INTRODUCTION

A. <u>What are Governance, Risk Management and Compliance</u>?

- **<u>GOVERNANCE</u>** ⇒ Process by which decisions relative to ⇒ (i) risk management and (ii) compliance are made within an organization ⇒ It's related to the <u>structures</u> and <u>controls</u> within an organization.
- **<u>RISK MANAGEMENT</u>** ⇒ processes by which risk is ⇒ Managed (not eliminated!)
  1. Identified;
  2. Analyzed;
  3. Included in strategic planning, and
  4. Either:
     a. Reduced through risk <u>mitigation</u> tactics or
     b. <u>Accepted</u> as inherent in the organization's activities.
- **<u>COMPLIANCE</u>** ⇒ <u>Processes</u> by which an organization ⇒ (i) <u>polices</u> its own behavior to (ii) ensure that it conforms to applicable rules and regulations.
  - It does not establish the applicable rules ⇒ it simply accepts them and ensures that they are observed.
  - Not simple checking boxes ⇒ Translate rules/guidance/administrative regulations into simple rules of behavior for the employees in the company.
- **<u>LAW OF GOVERNANCE, RISK MANAGEMENT AND COMPLIANCE ("GRC")</u>** ⇒ body of rules-regulations-best practices that, individually and collectively ⇒ intended to <u>ensure</u> that organizations achieve this <u>goal</u>
- One common purpose ⇒ ensure ORG are well managed.
  - o It also includes "soft law" recommendations from non-governmental organizations ⇒
    - Committee of Sponsoring Organizations of the Treadway Commission ("**COSO**") [umbrella organization of trade groups involved in GRC processes].
    - COSO defines **<u>INTERNAL CONTROL</u>** ⇒ Process implemented in an ORG (by BOD-management) to provide reasonable assurance regarding the achievement of objectives relating to operations, reporting and compliance.
      - (i) <u>Control environment:</u>
        [General tone of the organization: culture, attitudes, values, philosophy, human development procedures and operating style].
        [COSO =the most important element of internal control].
      - (ii) <u>Risk assessment</u>:
        [Process by which the organization (i) identifies and (ii) evaluates material risks to its operations- internal and external].
      - (iii) <u>Control activities</u>:
        [Procedures + policies that an organization employs to ensure that decisions made by the BoD/senior management are faithfully and competently executed throughout the organization].
      - (iv) <u>Information and communication</u>:
        [Means by which agents of the organization are supplied with the information needed to perform their duties].
      - (v) <u>Monitoring</u>:
        [Process of quality assurance - both on an ongoing basis as operations are performed, and separate evaluations conducted after the fact].
- Metaphor in this are: "**<u>Three lines of defense</u>**":
  (i) **<u>Line one ⇒ </u>Operating executives** ⇒ have initial responsibility for implementing internal controls within their own areas.

(ii) **Line two ⇒ Risk-management and compliance operations** ⇒ catch problems that are not weeded out at the front line.

(iii) **Line three ⇒ Internal audit** ⇒ checks up on everyone, including risk-management and compliance / ensure that no problems remain.

B. The Role of Attorneys:

- GRC ⇒ are cross-disciplinary in nature.
- Governance ⇒ significant legal element ⇒
  - Assigning compliance responsibilities within organizations (e.g., organizational documents, bylaws);
  - Determining compliance obligations (e.g., laws, regulations, judicial opinions).
- Compliance ⇒ large legal component ⇒
  - Manner in which compliance rules are administered are legal in nature.
  - L perform compliance investigations.
  - Other professions (accountant/computer technicians ⇒ also important role.
- Risk management ⇒ involves a combination of legal and non-legal considerations.
  - L can assess risks relating to legal liability
  - Other areas deal more competently with estimating in money many risks that organizations face.

C. Subject Areas:

- The law in this area is not the law of any particular field of activity or area of commerce; it is a topic that pertain to complex organizations.
- BUT ⇒ several regulations apply specifically to a determined field (e.g., regulation of healthcare, aviation, etc.)
- **Added value?** ⇒ helps ORG achieve its objectives while reducing risks + ensuring compliance with laws and regulations.

D. Update-Notes:

- Recent years ⇒ regulators have asserted increasingly exacting powers of review over the corporate governance practices of ORG under their supervision.
- Example ⇒ ***Basel Committee on Banking Supervision's "Core Principles of Banking Supervision,"*** ⇒ purports to set for the minimum acceptable standards for supervision of Banks around the world.

[See example – Update pg. 2-3]

[Check that banks ⇒ robust corporate governance polices and processes/ensure there is effective control/correct deficiencies in a timely manner/processes for nominating a D/D are experienced, suitable, effective, exercise duty of care and loyalty and some independent/BOD function includes audit and risk oversight/remuneration committees/risk appetite and strategy/establishes and communicates corporate culture and values/codes of conduct/ conflict of interest policies/control environment/fit and proper standards to select M/plans for succession/monitoring of M/BOD has appropriate incentives align with risk taking/

CHAPTER 1 – SHAREHOLDERS

PG. 13-26

PG 9-13 ⇒ OECD Corporate Governance Principles
Shareholders = SH
Board of Directors = BOD
Management = M
Independent Auditor = IA

SH ⇒ Economic interest in the company

- Profits ⇒ Dividends
- Share's price ⇒ may reflect the value of the company or the profits that have not been distributed as dividends
- If the value falls ⇒ SH incur in losses
- Liquidation ⇒ SH get a proportionate part of the distribution

A. PROS AND CONS OF SHAREHOLDER POWER

PROS	CONS
1.REDUCE AGENCY COSTS If SH have control rights over management ⇒ agency costs can be reduced	**1. NOT PRACTICAL** SH can't make decisions quickly –time consuming for them to make management decisions
2.HIGHER INTEREST FOR THE COMPANY TO DO WELL SH get the first part of the company's gain/losses ⇒ they have an interest for the company to do well. SH have an incentive to make profit-maximizing decision.	**2. HIGHER COSTS** It is costly to ascertain the SH's preferences ⇒ communicate issues to SH, get them to vote, collect votes, etc.
	3. MISINFORMED SH are not well informed about the decision they would have to make for the company. Most SH don't invest time or money in getting informed and make an informed vote ⇒ result ⇒ misinformed vote that will not contribute to the efficient management of the company. Even informed SH ⇒ don't have the judgment needed to make management decisions.
	4. DIVERSIFIED PORTFOLIOS Most SH hold diversified portfolios ⇒ They don't care deeply about one particular company ⇒ diversification reduces the interest SH have in monitoring management.
	5. EASY EXIT If SH are not happy in a public company ⇒ they can just sell their stock. ⇒ This also reduces the interest a SH has in one particular company.

	6. SOCIALLY INEFFICIENT DECISIONS SH would make socially inefficient decisions ⇒ their interests are not align with those of those of society. SH capture all the upside if company does well. If company does bad ⇒ most part of downside is borne by creditors (SH only losses the deductible). Moreover SH would prefer (or don't care) if the company undertakes risky investments/businesses.

Conclusion ⇒ SH should not be given 100% control of the decisions of the company (unworkable / not in anyone's best interest).

But ⇒ M does need to be oversight + company needs a system of check and balances.

SOLUTION ⇒ SH GET TO MAKE FUNDAMENTAL DECISIONS AND THE BOD/m GET TO MAKE THE OTHERS ⇒

1. **Election of BOD ⇒**
   [Even though SH don't make managerial decision ⇒ they select who will make them].
2. **Changes the company charter ⇒**
   [Normally, the ones proposed by the BOD].
   [*Questions and Comments* ⇒ nevertheless ⇒ BOD can make changes in the company's governance without the SH's approval ⇒ Example ⇒ Poison Pill/Shareholders Rights Plans].
3. **Fundamental corporate changes ⇒**
   [M&A, dissolutions, and sale of substantially all assets].
4. **Selection of the company's independent auditor ⇒**
   [Not required by law-but many companies allow SH voting/ratifying the election of IA].

B. ARTICLE – BEBCHUK – THE CASE FOR INCREASING SHAREHOLDER POWER

[More power for SH]

- SH should be able to adopt provisions that would give them subsequently specified power to intervene in additional corporate decision;
- Power to intervene in game-ending decisions (merge, sell assets, etc) ⇒ Addresses M bias in favor of the companies continued existence.
- Power to intervene in scaling-down decisions (make cash or in-kind contributions) ⇒ Addresses M tendency to retain cash and engage in empire-building.
- In general ⇒ would induce M to act in SH's interest.

C. ARTICLE – BAINBRIDGE – THE CASE FOR LIMITED SHAREHOLDER VOTING RIGHTS

[Less power for SH]

- Authority based decision-making structures are desirable ⇒ Division and specialization of labor.
- Delegating decision to BOD ⇒ Natural division of labor.
- Collective action problems ⇒ There are many SH, with diverse interests and different levels of information. Overcoming collective action problems is difficult and costly. SH don't have incentives to make sound operational decisions.
- *Questions and Comments* ⇒ Traditional allocation of authority between SH and M is a solution to the problem ⇒ Corporations can't be run effectively by SH as a whole ⇒ SH need to delegate responsibility to experts/specialist who can make decisions on a timely and informed basis.
- *Questions and Comments* ⇒ SH are not well equipped to make sensible decisions about M because they rely on market price. If the price drops, a SH can simple sell his share.

D. SHAREHOLDER PROPOSALS

[SEC RULE 14A-8]

PROCEDURAL CONSIDERATIONS	SUBSTANTIVE CONSIDERATIONS

Who can file?

- ➢ SH owning more than $2.000 in market value or more than 1% of the shares entitled to vote.
- ➢ For at least 1 year.
- ➢ Continue to hold the shares until the meeting.

What if one is not a SH of record?

- ➢ Submit statement from SH of record verifying ownership of relevant amount for relevant period-You need your holder of record or broker to give you a letter indicating that you are the BO of those shares

Number of proposals allowed?

- ➢ 1 per meeting

Length?

- ➢ 500 words

Deadline for submissions (annual meeting)?

- ➢ 120 calendar days before anniversary of filing of proxy statement for previous year's meeting.

Proponent/Rep must appear in person in meeting

If proposal fails to meet any of the procedural conditions?

- ➢ Company must notify SH
- ➢ SH can correct it
- ➢ If SH doesn't correct it ⇒ Company can submit a request of exclusion with the SEC (request for a "no-action letter").
- ➢ Proponent can respond to the request before the SEC.

1. Improper under state law

2. Violation of law

3. Violation of proxy rules

[Ex: violates Rule 14A-9-misleading statements]

4. Personal grievances-interests

[Ex: proposal that further personal interest and not he ones of the SH at large]

5. Relevance

[Ex: <5% of company's assets]

[Ex: Exclude proposals that don't relate to the company's core business]

6. Absence of power/authority

[Ex: company would lack power to implement it]

7. Management functions

[Ex: related to company's ordinary business operations]

8. Director elections

[If would disqualify nominee/remove director before term/question competence, BJ/seeks to include someone in the proxy/affects otherwise the outcome of upcoming elections]

9. Conflicts with company proposal

[M can use this to exclude SH's proposal by submitting proposal inconsistent with those of the SH]

10. Substantial implementation

[Ex: company has already implemented it]

11. Duplications

[More than 1 SH introducing a proposal regarding = topic]

12. Resubmissions

[Proposals that have not received sufficient support in previous years]

13. Specific amounts of dividends

*****Precatory resolutions***

[Recommend but don't require course of action]

Why use this? Pressure on the BOD/Test waters/leave the details to the BOD

*****Mandatory bylaw amendments***

[but can't never force BOD to take action directly]

Why not? 500 word limit/Compliance with 14A-8 requirements]

<u>Questions and Comments ⇒</u>

- Under # 1, any proposal that "imposes" mandatory duties on M could be improper under state law ⇒ In practice, SH avoid this hurdle by phrasing the proposal as a recommendation, suggestion or request (making votes advisory only).
- *Aggressive and proactive SH activism* ⇒ Organize SH in order to force the company to undertake some action – mostly hedge funds.
    - o Can get a lot of SH and can influence the BOD. Go in and demand changes from M.
- *Defensive Shareholder activism* ⇒ Focuses on structural reforms – encourage M to work hard and effectively to enhance the value of the company.

E. <u>SAY ON PAY (EXECUTIVE COMPENSATION)</u>

- **Say on pay votes are advisory only (NOT MANDATORY)**
- M is legally permitted to ignore SH on this.
- **<u>Questions and Comments ⇒</u>**
    - o In general SH approve M pay packages.

- Factors that could contribute to a “NO” vote ⇒ Poor performance/ Generous packages / Prior “no” votes / Negative recommendations from proxy advisory firms.
- Voting on pay packages in only as good as the information available to SH.
- SEC has long required companies to disclose information relating to executive compensation.

BOARD OF DIRECTORS PART I

Chapter 2, pp. 27 – 71 - Board of Directors

A. POWERS

- BOD = **ultimately responsible for governing a corporation. DGCL §141(a)**
- Responsibility can be shifted from the BOD in three ways:
    i. BOD COMMITTEES ⇒
        - Establish either by (a) action of the full BOD or (ii) in the corporation's governing documents.
        - State corporation laws authorize establishment of BOD committees.
        - Typically (not always) ⇒ everyone on a BOD committee must also be a member of the full BOD.
        - The committee may exercise an advisory role ⇒ it reports to the full BOD on particular topics;
        - BUT depending on governing documents ⇒ it can also exercise powers of the full BOD within the area of its competence. See DGCL §141(c)(2).
        - Exceptions ⇒ committee may NOT amend bylaws or act on a matter requiring SH approval.

    ii. GIVE FUNDAMENTAL MANAGEMENT DECISIONS TO PERSONS OUTSIDE BOD ⇒
        - Example ⇒ SH agreements or voting trusts may require shareholders or trustees to vote shares so as to accomplish defined outcomes. A company's governing documents might also purport to vest management powers outside the board by including a provision in its charter.

    iii. **BOD can delegate manage tasks to senior officers. DGCL §141(a)** recognizes two functions for the board: (a) managing a company, and (b) directing the management of a company.

- **The BODs of large organizations perform both activities, but the largest share of their time is spent on supervision**. The board's supervisory role **allows a central decision-maker to exercise overall control over the company's operations without becoming involved in the nitty-gritty details**.

- **But this function of delegating responsibility subject to oversight also carries risk**: If boards delegate responsibility too comprehensively, they may miss issues that are crucial to a firm's welfare. Worse yet, if senior executives do not provide accurate information to the BOD, BOD will be disabled from making the best decisions on behalf of shareholders. This problem of obtaining needed information from management is sometimes referred to as "asymmetric information" risk.

- **The problem of asymmetric information cannot be eliminated, but it can be mitigated if board members are active and involved**.

- **Compliance and risk management are the principal mitigation techniques** that supplement the board's role in supervision and oversight.
    - The **compliance function** addresses the risk that directors will miss violations of laws or other norms committed by others in the organization;
    - **The risk management function deals with the problem that directors will miss threats to the company's welfare that are inherent in its business**.

- o Thus, risk management and compliance can be understood as instruments designed to enhance and improve the management function in complex organizations.

B. SIZE

- The matter of the BOD size involves tradeoffs of benefits and costs. **Each new board member brings new insights and a new perspective. On the other hand, as the size of a board increases, individual responsibility for decisions may decrease.** Moreover, the **difficulty of organizing a coalition increases as well**. These organizational difficulties, in turn, might make it difficult for a large board to resist the wishes of the CEO or other senior managers.

- Empirical studies suggest **that BODs become less effective once they cross a certain threshold of size** (David Yermack). In other words, as boards grow large, the market has a less favorable view of the company's prospects.

- **Advisory board members can bring new or broader perspectives to the organization and have those views heard at the highest strategic level**. They may represent political accommodations which smooth out difficult transitions, as when the company has acquired another firm and keeps the former firm's former managers or board members on retainer in an advisory capacity. They may represent means for providing a voice, if not a vote, to constituencies other than shareholders.

- What are the **disadvantages** of advisory boards? **They are not vetted or elected by shareholders but may play an important role in decision making**. They may bring conflicts or interest into play. Their commitment to the company may be limited by the restricted nature of their appointments. They may create external confusion if their titles sound too much like regular board positions.

C. Terms of Office

- Board members are **typically appointed for a term of office defined in the organization's fundamental organizing document.** In many cases, all board members are elected **annually**. The BOD may also be "**staggered.**" A staggered board is one in which the directors serve for multi-year terms and only a minority (usually one-third) are elected each year.

- Staggered boards have obvious benefits, the most important of which is continuity in office. The directors who remain in office are able to bring their collective experience of managing the company to bear in its challenges going forward, and can instruct newly elected directors on the fine points of their jobs.

- Because less than half the board can be replaced in any given year, **it is impossible for someone who takes over the company to gain control over the BOD unless** either (a) incumbent members **voluntarily leave offic**e, or (b) the dissident who takes over a majority of the company's stock is able to use existing corporate powers to **remove incumbent directors involuntarily**. The **latter is usually very difficult**, often requiring a finding of incapacity or misconduct in office. The former may be impossible if the takeover is hostile and the incumbent board members remain loyal to the former managers.

- A considerable body of scholarship argues that staggered boards represent a **highly effective defense against hostile corporate takeovers**.

- This and other studies sparked a campaign to eliminate staggered boards, spearheaded by Harvard Law School's Shareholder Rights Project and other corporate governance activists.

D. Proposal to Repeal Classified Board

- Shareholders of Sally Beauty Holdings, Inc. urge the BOD to take all necessary steps to eliminate the classification of the BOD. In their supporting statement, they argue that having directors stand for elections annually makes directors more accountable to shareholders, and could thereby contribute to improving performance and increasing firm value. They also pointed out that the significant shareholder support for declassification proposals is consistent with empirical studies reporting that: (a) classified boards are associated with lower firm valuation; (b) takeover targets with classified boards are associated with lower gains to shareholders; (c) firms with classifies boards are more likely to be associated with value-decreasing acquisition decisions; and (d) classified boards are associated with lower sensitivity of compensation to performance and lower sensitivity of CEO turnover to firm performance.

- Board of Directors' Statement in Opposition: The Board's Nominating and Corporate Governance Committee, comprised entirely of independent directors, and the Board have considered the arguments against a classified board structure and recommended a vote "against" the stockholder proposal to repeal the classified board, for the following reasons:

(a) Consistently Strong Financial Performance

- The Board believes that there is no "one size fits all" approach that suits all companies. It believes that its classified structure provides important advantages to the Corporation and is in the best interests of the Corporation and its stockholders.
- The proponent's assertions are quite inconsistent with the Corporation's sustained record of strong financial performance.
- The Corporation has significantly outperformed the S&P 500 Index in recent years. Thus, the Board believes that changing the Corporation's long-standing governance structure simply to "fall in line" with S&P 500 firms would be a considerable disservice to the Corporation's stockholders.

(b) Maximization of Stockholder Value in Change of Control Transactions

- A classified board does not, and is not intended to, preclude a takeover, and it does not alter the fiduciary responsibilities of the directors in responding to any such efforts. A classified board causes potential acquirors to attempt to negotiate the terms of a transaction with the Board; negotiate the best possible return for all stockholders.

(c) Other Empirical Research

- There are a couple of studies that reach a different conclusion, which could support the view that classified boards may benefit stockholders.

Accountability to Stockholders

- The proponent's assertion that the classified board structure diminishes director accountability to stockholders is debatable. Directors elected to three-year terms are equally as accountable to stockholders as directors elected annually because all directors are required by law to fulfill their fiduciary duties to the Company and its stockholders.

(d) Board Stability and Continuity

- The classified board structure is designed to provide stability and continuity of leadership, prevent sudden disruptive changes to the Board composition, enhance long-term planning and ensure that at any given time a majority of directors will have served for multiple years. Declassification of the Board could result in higher turnover of Board members and have an adverse impact on the effectiveness of the Board.

(e) Director Independence

- Electing a director to a three-year term enhances the independence of a non-employee director by providing him or her with a longer term of office.

- Notice that the lack of a staggered board does not mean that board members will turn over more quickly. The only difference is that they are up for election more frequently and that they can be more easily ousted in the event of a takeover.

E. <u>Qualifications</u>

a. Independence

- A key distinction among board members is whether or not they are independent.
  - **An inside directors** is someone employed by or otherwise linked to the company for reasons other than his or her service as a director;
  - **an independent director is someone without these connections**.
  - Many corporate boards – and all or nearly all boards of publicly traded companies – include both independent and inside directors.

- **Senior executives offer important benefits**:

- They are **intimately involved in the management of the company** and are equipped to assess the best use of the available human resources.
- They have a **commitment to the enterprise which is both financial and reputational**.

- But **inside directors also bring deficits** to the table:

- **They are likely to think along lines** which are set within the organization.
- If they are not the CEO, **they may find themselves limited in what they can say on the board because of fear that the CEO**, who controls their possibilities for promotion, may not approve.
- Insiders usually **want to be paid more rather than less**, but every dollar paid to senior managers is a dollar not available to the company for useful projects or for dividends.
- Insiders tend to value the powers and perquisites of their jobs; **they may wish to entrench themselves** in office rather than allow the company to be acquired by an outside bidder who might push them over the transom, even if the bidder is offering superior value to shareholders.
- **Insiders may be incompetent or unmotivated**, and thus may prefer that the BOD not closely scrutinize their job performance.

- **Independent directors** offer a partial solution to these limitations:

- They often come from **different backgrounds** and bring a **different perspectiv**e to bear on strategic issue.
- Not being employed, they are **less concerned about offending the CEO**.
- They are compensated for their work, but only on a part-time basis; their conflict of interest over the matter of compensation is less severe.
- **Independent directors value the benefits that come from board service, and thus**, like inside directors, have an incentive to entrench themselves in office; but because the work is only part-time and is rarely the principal source of an independent director's income, the entrenchment motivation is likely to be less problematic.
- Independent directors have **no incentive to allow the company's executive officers to behave in an incompetent or unmotivated way**, and so are more likely to insist on good job performance.
- Independent directors have a **public-relations function**.

- Yet **independent directors are also limited** in their capacity to manage:

- They **can never have the knowledge base that an insider director brings to the table**.
- Having **only a fraction of their personal wealth and reputational capital tied up in the firm**, they have less to lose if it does poorly.
- The **independence of independent directors is sometimes in question**. They are often connected to senior management by myriad ties of acquaintance, friendship, and shared interests.

- The mix of independent and inside directors observed in large companies reflects a balancing of these factors.

- There is some **evidence that audit committees comprised of independent directors discourage companies from engaging in "earnings management"** (manipulating financial operations and reporting so as to show steady growth of profits over time).

- **The presence of independent directors also seems to increase the likelihood that companies will face a hostile takeover bid**. The theory is that because independent directors are not as entrenched in office as inside directors, they will be less likely to resist a takeover which will result in the ousting of the current management.

- The distinction between inside and independent directors is important for a number of reasons beyond their respective contributions to firm performance. **Companies whose shares are listed for trading on national securities exchanges must satisfy listing standards promulgated by those organizations. Both NYSE and NASDAQ require that the majority of directors of a listed company be independent**. All members of the audit, compensation, and nominating committees of the board – if established – must be independent.

- The NYSE Listed Company Manual §303A.02 contains a **definition of "independent director"** for its purposes.

- The NYSE Listed Company Manual indicates that it is best that boards making "independence" determinations broadly consider all relevant facts and circumstances. Material relationships can include commercial, industrial, banking, consulting, legal, accounting, charitable and familial relationships.

- **Owning a large amount of a company's stock, in itself, does not deprive a director of independence**. According to the NYSE, the reason is that "**the concern is independence from management**."

- Independence can have a different meaning in the context **of special committees set up to assess the merits of shareholders derivative litigation**. **Even directors who are formally independent for other purposes may not be considered independent for the purposes of these special committees**, if their contacts with senior managers or other interested parties are such as to raise questions about their ability to act in the best interests of the company and its shareholders.

b. Skills

- **There is no general requirement that corporate directors undergo professional training**, obtain specialized degree, pass examinations, or participate in continuing professional education programs. State corporate codes typically impose no competency or educational requirements on directors, beyond perhaps a minimum age threshold.

- There are, however, **certain areas where particular skills are specified by law**. **Audit committee members may have to display a minimum level of competence about finance; and at least one of them may need to have more substantial skills in finance, accounting, or related matters**. When companies get into trouble, the regulators may become more demanding. In the case of national banks, the Comptroller of the Currency can exercise plenary control over the selection (or removal) of directors when a bank under its supervision becomes undercapitalized.

- **Aside from regulatory action, companies may impose requirements for directors voluntarily. DGCL §141(b) recognizes that a company's governing documents "may prescribe other qualifications for directors."**

c. **Diversity**

- Women and minorities are under-represented on corporate boards relative to their share of the population. Possible reasons why a company might deem it desirable to include on the board people from groups that have traditionally been excluded from board membership:

- **Introduce a valuable perspective** on the issues facing the board and thus contribute to effective decision-making.
- **Signal to the company's employees that the firm has an inclusive corporate culture**.
- Foster mentoring relationships.
- Generate a **favorable view of the firm** in the public or in particular market segments.
- Reassure investors that the company is not tone-deaf on **important public issues**.
- Convince activists that the company has progressive views on social issues, and therefore that it should not be signaled out for criticism.
- **Reassure regulators that the firm is eager to implement good governance practices** and that it is compliant with changing social norms, thus deflecting potential enforcement scrutiny.

F. Fiduciary Duties

- Directors are subject to a legal duty to perform their responsibilities faithfully and well. But that duty is only sporadically enforced, and sometimes not enforced at all.

- The director's legal responsibility is captured in the idea that directors are "fiduciaries" and that they owe companies and shareholders a "fiduciary duty." The directors' fiduciary duty is the duty they owe to their firms, and, indirectly, to the firm's shareholders (and possibly other constituents).

- However, **in only one area – the duty of loyalty – is the fiduciary duty strictly enforced**; and even there, a director blessed with good legal advice and an ability not to be too greedy can avoid most liability exposure. In other respects, the fiduciary duty of corporate directors is hardly enforced at all.

a. The Duty of Care

In re Citigroup Inc. Shareholder Derivative Litigation

- Shareholders derivative action claiming that the BOD of Citigroup breached their fiduciary responsibility to the company by (among other things) making improvident investments in subprime mortgage securities. The Delaware Chancery Court rejected the theory in definitive terms:

Plaintiffs' theory essentially amounts to a claim that the director defendants should be personally liable to the Company because they failed to fully recognize the risk posed by subprime securities.

The doctrines of fiduciary duty of care and the business judgment rule properly focus on the decision-making process rather than on a substantive evaluation of the merits of the decision.

The business judgment rule "is a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company." The burden is on plaintiffs, the party challenging the directors' decision, to rebut this presumption. Thus, absent an allegation of interestedness or disloyalty to the corporation, the business judgment rule prevents a judge or jury from second guessing director decisions if they were the product of a rational process and the directors availed themselves of all material and reasonably available information.

- **DGCL §102(b)(7)** allows a Delaware corporation to include in its certificate of incorporation a provision that **eliminates liability of directors for money damages in lawsuits based on violations of the duty of care**. For companies that adopt the charter provision, the statute makes it clear that, absent special circumstances, directors face no exposure for money damages in lawsuits claiming violations on the duty of care.

- What is the rationale for the business judgment rule and other director-protecting principles such as §102(b)(7)? Two theories: (a) the first idea is that directors of corporations know more than courts know about the business decisions they have to make; (b) the second idea has to do with timing. The court in the excerpted case thinks judges are prone to hindsight bias and therefore may tend to be overly harsh in their evaluation of managerial decisions that have bad outcomes. The business judgment rule counteracts this tendency by requiring judges to credit the good faith and reasonableness of managerial decisions unless the contrary is shown.

- Other possible explanations for the business judgment rule:

- Shareholders tend to hold diversified portfolios of securities, and thus are insulated from the consequences of mistakes by the managers of any given corporation.
- Corporate managers are subject to market discipline that doesn't exist for other fiduciaries. Corporate managers have strong incentives to perform their responsibilities well even in the absence of an enforceable duty of care.
- In the case of public corporations, imposing personal liability on directors would do little to rectify the harm since the amount of damages will far exceed their resources.
- If responsible people feared having to pay damages for violations of the duty of care, they would not want to serve on corporate boards.
- States compete to attract corporate charters because of the tax revenue and other benefits that this business brings in. If a state imposed duty of care with any significant threat of liability, companies would simply re-charter in a more accommodating jurisdiction.

b. **The Duty of Loyalty**

- The principal way that the presumption can be rebutted, under modern corporate law principles, is to show that the defendant director or controlling shareholder had a conflict of interest in the transaction in question.

In re Southern Peru Copper Corp. Shareholder Derivative Litigation

- The controlling stockholder of an NYSE-listed mining company came to the corporation's independent directors and proposed that the company buys his non-publicly traded Mexican mining company for approximately $3.1 billion of the former NYSE-listed stock. A special committee was set up to "evaluate" this proposal and it retained well-respected legal and financial advisors.

The financial advisor told the special committee that the value of the "get" was more than $1 billion less.

Rather than dismissing the controlling shareholder, the special committee and its advisors instead did something that is indicative of the mindset that too often afflicts even good faith fiduciaries trying to address a controller.

Abandoning a focus on whether the NYSE-listed mining company would get $3.1 billion in value in the exchange, the special committee embarked on a "relative valuation" approach. Apparently perceiving that its own company was overvalued and had a fundamental value less than its stock market trading price, the special committee assured itself that a deal could be fair so long as the "relative value" of the two companies was measured on the same metrics.

Rather than reacting to these realities by suggesting that the controller make an offer for the NYSE-listed company at a premium to what the special committee apparently viewed as a plush market price, or making the controller do a deal based on the Mexican company's standalone value, the special committee and its financial advisor instead took strenuous efforts to justify a transaction at the level originally demanded by the controller.

The court concluded that this transaction was unfair. A focused, aggressive controller extracted a deal that was far better than market, and got real, market-tested value of over $3 billion for something that no member of the special committee, none of its advisors, and no trial expert was willing to say was worth that amount of actual cash.

The court then ordered the controller to return to the NYSE-listed company a number of shares necessary to remedy the harm. The court awarded damages of $1.263 billion plus pre-judgment and post-judgment interest.

- The plaintiff did not question their independence. The directors don't sound like pushovers. But as the court describes the facts they seemed awfully willing to cater to the wishes of the controlling shareholder.

c. **Caremark and the Duty of Oversight**

- What is the board's responsibility for ensuring that the companies they serve comply with applicable laws and regulations? Given that the board is responsible for overseeing the management of the corporation, and that compliance is a key part of management, it **would seem straightforward to say that the board is responsible for compliance.**

- **The statement is true, of course, and also important. Yet, if not backed by some sort of legal sanctions, the requirement to ensure compliance may, in some cases, go unfulfilled.**

In re Caremark International Inc. Derivative Litigation (Del. Ch. 1996)

- Caremark was involved in two main health care business segments, providing patient care and managed care services.

- A substantial part of the revenues generated by Caremark's businesses is derived from third party payments, insurers, and Medicare and Medicaid reimbursement programs. The latter source of payments are subject to the terms of the Anti-Referral Payments Law ("ARPL") which prohibits health care providers from paying any form of remuneration to induce the referral of Medicare or Medicaid patients.

- As early as 1989, Caremark's predecessor issued an internal "Guide to Contractual Relationships" to govern its employees in entering into contracts with physicians and hospitals. The Guide stated as Caremark's and its predecessor's policy that no payments would be made in exchange for or to induce patient referrals.

- In August 1991, the HHS Office of the Inspector General ("OIG") initiated an investigation of Caremark's predecessor. In March 1992, the DOJ joined the OIG investigation and separate investigations were commenced by several additional federal and state agencies.

- <u>As a result, Caremark's Board took several steps consistent with an effort to assure compliance with company policies concerning the ARPL and the contractual forms in the Guide, including the employment of PWC, who concluded that there were no material weaknesses in Caremark's control structure.</u>

- On August 4, 1994, a federal grand jury in Minnesota issued an indictment charging Caremark, two of its officers, and others, with violating the ARPL over a lengthy period. According to the indictment, over $1.1 million had been paid to Brown, during the period from 1986 through 1993, to induce him to distribute Protropin, a human growth hormone drug marketed by Caremark. Some payments were "in the guise of research grants", and others were "consulting agreement."

- Subsequently, **five stockholders derivative actions were filed and consolidated. The complaint alleged that Caremark's directors breached their duty of care by failing adequately to supervise the conduct**

of Caremark employees, or institute corrective measures, thereby exposing Caremark to fines and liability.

- Caremark began settlement negotiations with federal and state government entities in May 1995. In return **for a guilty plea** to a single count of mail fraud by the corporation, the payment of a criminal fine, the payment of substantial civil damages, and cooperation with further federal investigations on matters relating to the OIG investigation, the government entities agreed to negotiate a settlement that would permit Caremark to continue participating in Medicare and Medicaid programs.

- As a result Caremark undertook **some commitments**: (i) Caremark undertakes that it and its employees, and agents not pay any form of compensation to a third party in exchange for the referral of a patient to a Caremark facility or service or the prescription of drugs marketed or distributed by Caremark for which reimbursement may be sought from Medicare, Medicaid, or a similar state reimbursement program; (ii) that the full Board shall discuss all relevant material changes in government health care regulations and their effect on relationships with health care providers on a semi-annual basis; (iii) that the Board will establish a Compliance and Ethics Committee of four directors, two of which will be non-management directors, to meet at least four times a year to effectuate these policies and monitor business segment compliance with the ARPL, and to report to the Board semi-annually concerning compliance by each business segment; and (iv) that corporate officers responsible for business segments shall serve as compliance officers who must report semi-annually to the Compliance and Ethics Committee and, with the assistance of outside counsel, review existing contracts and get advanced approval of any new contract forms.

- **The complaint charges the director defendants with breach of their duty of attention or care in connection with the on-going operation of the corporation's business**. The complaint thus does not charge either director self-dealing or the more difficult loyalty-type problems arising from cases of suspect director motivation, such as entrenchment or sale of control contexts.

- Director liability for a breach of the duty to exercise appropriate attention may, in theory, arise in two distinct contexts. First, such liability may be said to follow from a board decision that results in a loss because that decision was ill advised or "negligent". Second, liability to the corporation for a loss may said to arise from an unconsidered failure of the board to act in circumstances in which due attention would, arguably, have prevented the loss.

- **Whether a judge or jury considering the matter after the fact, believes a decisions substantively wrong, or degrees of wrong extending through "stupid" to "egregious" or "irrational", provides no ground for director liability, so long as the court determines that the process employed was either rational or employed in a good faith effort to advance corporate interests**.

-Thus, the business judgment rule is **process oriented and informed by a deep respect for all good faith board decisions.** Where a director in **fact exercises a good faith effort to be informed and to exercise appropriate judgment, he or she should be deemed to satisfy fully the duty of attention**. The core element of any corporate law duty of care inquiry is whether there was good faith effort to be informed and exercise judgment.

- The second class of cases in which director **liability for inattention is theoretically possible entail circumstances in which a loss eventuates not from a decision but, from unconsidered inaction.** Legally, the board itself will be required only to authorize the most significant corporate acts or transactions: mergers, changes in capital structure, fundamental changes in business, appointment and compensation of the CEOs.

- The Court then concluded that **a director's obligation includes a duty to attempt in good faith to assure that a corporate information and reporting system**, which the board concludes is adequate, **exists, and that failure to do so under some circumstances may, in theory at least, render a director liable for losses caused by non-compliance with applicable legal standards**.

- The record in this case supplies essentially **no evidence that the director defendants were guilty of a sustained failure to exercise their oversight function. To the contrary, the corporation's information systems appear to have represented a good faith attempt to be informed of relevant facts**.

- The liability that eventuated in this instance was huge. But the fact that it resulted from a violation of criminal law alone does not create a breach of fiduciary duty by directors. The record at this stage does not support the conclusion that the defendants either lacked good faith in the exercise of their monitoring responsibilities or consciously permitted a known violation of law by the corporation to occur.

- Chancellor Allen derives a compliance duty from the traditional rule that, although decisions made in the exercise of business judgment are protected against liability, the rule does not protect directors if they fail to exercise judgment at all. This implied that a board has a duty to ensure itself that compliance systems are in place.

Stone v. Ritter (Del. 2006)

- This case grew out of allegations that, in providing banking services to customers who turned out to be operating a **Ponzi scheme**, AmSouth Bank had failed to comply with the requirements of the Bank Secrecy Act (BSA) and federal anti-money laundering (AML) regulations. Numerous enforcement actions against the bank followed, and the bank was also subject to criminal fine and civil money penalty. The penalty was based, in part, on the finding that "AmSouth's [AML compliance] program lacked adequate board and management oversight," and that "reporting to management for the purposes of monitoring and oversight of compliance activities was materially deficient."

- Shareholders brought a derivative lawsuit against the bank's directors for breach of fiduciary duty. They acknowledged that the directors neither knew nor should have known that violations of law were occurring, but argued that their case **should proceed because the defendants had failed to implement monitoring, reporting, or information controls that would have enabled them to learn of problems requiring their attention**.

- The Caremark standard **for so-called "oversight" liability draws heavily upon the concept of director failure to act in good faith,** which includes where the fiduciary intentionally fails to act in the face of a known duty to act, demonstrating a conscious disregard for his duties. This is fully consistent with the lack of good faith conduct that the Caremark court held was a "necessary condition" for director oversight liability.

- **We hold that Caremark articulates the necessary conditions predicate for director oversight liability: (a) the directors utterly failed to implement any reporting or information system or control; or (b) having implemented such a system or controls, consciously failed to monitor or oversee its operations this disabling themselves from being informed of risks or problems requiring their attention**. In either case, imposition of liability requires a showing that the directors knew that they were not discharging their fiduciary obligations. Where directors fails to act in the face of a known duty to act, thereby demonstrating a conscious disregard for their responsibilities, they breach their duty of loyalty by failing to discharge that fiduciary obligation in good faith.

- **The court ruled that the allegations in the complaint failed to create a reasonable inference of director liability**. The Board received and approved relevant policies and procedures, delegated to certain employees and departments the responsibility for filing suspicious activity reports and monitoring compliance, and exercised oversight by relying on periodic reports from them.

- This Delaware Supreme Court ruling confirms the validity of Caremark liability under Delaware law, recognizes the generality of its application, and provides information about the scope of the duty.

Rich ex rel. Fuqi Intern, Inc. v. Yu Kwai Chong

- Fuqi, originally a Chinese corporation, gained access to U.S. capital markets and raised more than $120 million from investors in a public offering in 2009.

- **Problems surfaced in 2010, when the company disclosed significant deficiencies in its financial controls and restated earnings. Worse yet, it turned out that Chong, Fuqi's Chairman, had distributed approximately $130 million to unnamed parties in China**. The **stock was delisted from NASDAQ** and, at the time of the opinion, traded in the "pink sheets" at approximately $1/share.

- The derivative Plaintiff alleges that **Fuqi's directors are liable for failure to oversee the operations of the corporation.**

- To survive a motion to dismiss, the plaintiff must plead facts that allow a reasonable inference hat the defendants knew they were not fulfilling their fiduciary duties.

- One way a plaintiff may successfully plead a **Caremark claim is to plead facts showing that a corporation had no internal controls in place. Fuqi had some sort of compliance system in place. However, the mechanisms Fuqi had in place appear to have been woefully inadequate**.

- These disclosures lead the Court to believe that **Fuqi had no meaningful controls in place**. The BOD may have had regular meetings, and an Audit Committee may have existed, but there does not seem to have been any regulation of the company's operations in China. He stressed that even if Fuqi had some system of internal controls in place, the board's failure to monitor that system was a breach of fiduciary duty.

- As the Supreme Court held in Stone v. Ritter, if the directors have implemented a system of controls, a finding of liability is predicated on the directors' having "consciously failed to monitor or oversee [the system's] operations thus disabling themselves from being informed of risks or problems requiring their attention." **One way that the plaintiff may plead such a conscious failure to monitor is to identify "red flags," obvious and problematic occurrences, that support an inference that the Fuqi directors knew that there were material weaknesses in Fuqi's internal controls and failed to correct such weaknesses**. At the very least, the Fuqi board had several "warnings" that all was not well with the internal controls as far back as March 2010.

- **It is reasonable, based on the facts pled, to infer that the directors knew that the internal controls were inadequate and failed to act in the face of a known** duty.

- That Chong was able to transfer $130 million out of the company's coffers, without the directors knowing about it for over a year, strains credulity. Either the directors knew about the cash transfers and were complicit, or they had zero controls in place and did not know about them. If the directors had even the barest framework of appropriate controls in place, they would have prevented the cash transfers.

- **A conscious failure to act, in the face of a known duty, is a breach of the duty of loyalty**.

- Finally, Fuqi management's failure to pay the fees of the Audit Committee's advisors is a deliberate failure to utilize the Audit Committee. Therefore, the board has disabled itself from being informed.

- For the reasons above, the Court found that the Plaintiff has stated a claim under Caremark upon which relief could be granted.

G. <u>Chairman</u>

- **The BOD is led by a "chairman". The chairman gets only one vote**, same as every other board member; her principal **official power is to lead meetings of the board**. It would be a mistake, however, to conclude that the chairman of the board is merely first among equals. Usually, **the chairman's position is one of**

considerable power and influence: (i) she **sets the agenda** of board meetings; (ii) under a company's bylaws, **the chairman is often elected by the other directors**; (iii) she is **seen** from without **as the leader of the company**; and (iv) the chairman has historically exercised disproportionate power in American companies.

- **When she also serves as the CEO, her power is multiplied. For this reason, corporate governance advocates have campaigned to split these offices by prohibiting the chairman from also serving as CEO**. Shareholder proposals to this effect are frequently included for vote at annual meetings. These proposals enjoy relatively wide support from institutional investors and other constituents.

- Hess Corporation's 2013 proxy statement sets forth the case for and against separating the offices of board chairman and CEO, as summarized below:

Supporting Statement from Stockholder Proponent

- It is the responsibility of the Board to protect shareholders' long-term interests by providing independent oversight of management, including the CEO, in directing the corporation's business and affairs.
- We believe that the practice of combining the two positions may not adequately protect shareholders.
- We believe that an independent Chairman who sets agendas, priorities and procedures for the boar can enhance board oversight of management and help ensure the objective functioning of an effective board.
- Having an independent Chairman can improve accountability to shareholders.
- A number of respected institutions recommended such separation (CalPERS' Corporate Core Principals and Guidelines, Milstein Center at Yale School of Management, The Conference Board).
- We believe that the recent economic crisis demonstrates that no matter how many independent directors there are on the Board, that Board is less able to provide independent oversight of the officers if the Chairman of that Board is also the CEO of the Company.

Board of Directors Statement

- The stockholders are best served by giving the board the organizational flexibility to select the best person to serve as chairman. Effective corporate governance requires more than a "one size fits all" approach.
- At present, the board believes this structure promotes better alignment of strategic development and execution, more effective implementation of strategic initiatives, and clearer accountability for their success or failure. In addition, the company's chief executive officer has the necessary experience, commitment and support of the other board members to also effectively carry out the role of chairman.
- Having the CEO both lead management and chair the board has allowed the company to obtain the benefit of his strategic and operational insights and strong leadership skills across the full range of responsibilities of the company's leadership, from long-term strategic direction to day-to-day operational execution.
- The board regularly reviews this leadership structure and believes that combining the chairman and CEO positions at this time does not impede independent oversight. The board has taken several steps to create a balanced governance structure in which independent directors exercise substantial oversight over management. The board is currently composed of 14 individuals, 12 of whom are independent, and the members of each of the keyboard committees are independent.
- The board has a lead independent director who is elected by the independent members of the board and whose responsibilities are substantially similar to many of the functions typically fulfilled by a board chairman.

- Less than a week before the annual meeting, Hess Corporation did a volte-face and announced that it would separate the positions of chairman and CEO.

- There were factors at play other than the merits of splitting the position of CEO and chairman of the board. Hess was involved in a proxy battle with a large institutional investor, Elliott Management Corporation, controlled by billionaire Paul Singer, which held 4.5% of the company's stock. Elliot disagreed with the strategic direction being followed by the incumbent managers, which was to exit refining, gasoline retail, and other businesses to become a pure oil exploration and production company. Elliot nominated its own slate of directors and solicited proxies for their election instead of the directors favored by management.

- Hess's strategy wasn't enough to deter Elliot from continuing the proxy fight. However, the parties settled: Elliot agreed to support five of the company's board nominees in exchange for three seats of its own.

The board of directors (p. 71 – 102)

1. Lead directors

- As a partial corrective for the concentration of power in the hands of an inside chairman of the board, **some companies appoint a lead independent director, whose role is to play a leadership role among the independent directors** and also to act in the chairman's role when the chairman is unable to perform that responsibility

2. Audit committee

- Boards of directors are authorized to delegate specific functions to committees composed of only some board members.
- **For purposes of compliance the most important committee is usually the audit committee.**
    - The audit function is one of **checking-making sure that procedures are followed and items are properly recorded**. Compliance is also a process of **checking-ensuring that applicable norms of conduct are being followed by employees.**
    - When compliance became recognized as an independent function of the board of directors, it was naturally assigned to the audit committee.
- **The audit committee is usually responsible for**:
    - Overseeing the company's compliance operation. In this capacity the audit committee receives regular reports from the company's chief compliance officer.
    - In order to ensure the free flow of information the audit committee typically has discretion to meet with the compliance officer in private time
    - Audit committee members must satisfy competence qualifications
        - Each public company must disclose whether it has a financial expert on its audit committee and if not why not.
        - NASDAQ goes further, audit committee member of NASDAQ listed companies must include at least one member who has pas experience in finance or accounting etc.

3. Risk committees

- The responsibilities of audit committees have grown by accretion over the years. As **new tasks and new responsibilities evolved for the board of directors to manage, it was convenient to vest many of these in a committee**.
- However, the accumulation of tasks has tended to deflect the focus of the audit committee away from its core function of financial control and **has overburdened audit committees to the point where their ability to perform their tasks responsibly might be in jeopardy**.
- Accordingly **new committees have been created to take over some of the burden and to focus on tasks**, which are deemed to be discrete, important and outside the central competence of the audit committee. **One such risk is risk management**.

- **Many companies assign responsibility for risk management to a special committee of the board of directors**.
- **Item 407 (h)** of SEC Regulation requires public companies to **disclose the extent of their board's role in overseeing the organization's risk exposure**, including how the board administers its risk oversight function and how the leadership structured accommodates such a role.
- **§165(h) of the Dodd-Frank Act**, which directs the Federal Reserve Board to require certain large bank holding companies and systemically important nonbank financial companies to **establish a board risk committee** that is responsible for **oversight of enterprise-wide risk management**, is comprised of **independent directors** and includes at least **one risk management expert**.
- Risk committees operate under charters approved by the full board of Directors.

4. **Additional reading (Professor's up-date):**
   - In Europe, legislation implementing the **Basel III capital standards now requires that the management of European banks must "ensure that the management body devotes sufficient time to consideration of risk issues**.
   - **Larger European Banks are required to establish "risk committees" composed of members of the management body who do not perform any executive function** in the institution concerned. The members of that committee shall have appropriate skills, knowledge and expertise.
   - **MRA (matters requiring attention)** – a controller of the currency issues such MRA's when a bank examination detects significant deficiencies in practice.
   - How should the governance and nominating committee handle the situation when a CEO runs into trouble or experiences difficulty handling the job?
   - The following aspects play a role:
     - CEO is central to the success or failure of any company, any factors that impair his effectiveness should be matters of concerns
     - But how should one act in such a situation?
     - Most CEO's wish to keep their job
     - This brings along significant reputational concerns both for the CEO's personal reputation as well as the reputation of the organization
     - What happens if the CEO leaves the company? What payments are due, vesting rights or other benefits?
     - The situation is difficult and dangerous and requires wise judgment on the part of the board members
     - Consider the following case which faced these problems

5. **Klassen v. Allegro Development Corporation** (Delaware Supreme Court 2014)
   - Facts:
     - Eldon Klaassen founded Allegro in 1984 and was its CEO until November 1, 2012. Klaassen also owned nearly all of Allegro's stock until late 2007 and early 2008, at which time Allegro raised capital through the sale of a preferred class of stock to two private equity firms. Following the investment, Allegro's board consisted of two members appointed by the new investors, two members

appointed by Klaassen in his capacity as CEO and approved by the new investors, and Klaassen.

- The Allegro board eventually became dissatisfied with Klaassen's leadership and, at a regularly scheduled board meeting on November 1, 2012, terminated his employment and appointed one of the board members appointed by Klaassen as interim CEO. Klaassen remained as a director. Although Klaassen acted initially in a manner suggesting acceptance of the change – e.g., he agreed to serve on the audit and compensation committees of the board at a subsequent board meeting – by mid-2013 Klaassen sent a letter to Allegro's general counsel and two of its board members arguing that his removal as CEO was invalid.

- Judgment:
  - The Chancery Court ruled against Klaassen,
  - Klaassen argued that these cases "recognize a special equitable notice requirement that benefits any individual who is (i) both an officer and a director and (ii) can exercise a right that could alter the composition of the board."
  - **The Chancery Court concluded that the Koch line of cases "reveals tensions...with Delaware's director-centric system of corporate governance... [but does] present serious legal questions" relevant to the claim in Klaassen.**
  - While the Chancery Court's review of the Koch line of cases was interesting and entertaining from a historical and theoretical perspective, **the Chancery Court ultimately avoided deciding Klaassen on the basis of those cases, instead holding against Klaassen on the basis of the equitable principle that Klaassen had acquiesced in the termination of his employment.**
  - In affirming the Chancery Court's decision, the Supreme Court sidestepped the Chancery Court's questioning of the holdings of the Koch line of cases ("we need not respond to that question, as an answer is not required to resolve this case") and instead **resolved Klaassen's appeal in favor of Allegro and the defendant directors on the basis of a straightforward application of Delaware's notice requirements and of equitable principles**.
  - The notice requirement distinction with respect to regular and special meetings is an important practice:
    - **"It is, of course, fundamental that a special meeting held without due notice to all the directors is not lawful, and all acts done at such meeting are void.**
    - **As to regular, or stated, meetings the rule is different. Presence at the meeting waives the notice, and so may a waiver be properly executed before the meeting, for there is still an opportunity to attend it. But a waiver subsequent to the meeting is ineffective."**
  - The Supreme Court's decision in Klaassen strongly implies, although the issue is dicta, that **directors must be given "advance notice of the specific agenda items to be addressed" at special board meetings in order for the actions at those meeting not to be void**.
  - As to the issue of deception, while Klaassen had reason to know that his tenure as CEO of Allegro was in jeopardy, the Supreme Court found that the other Allegro directors "decided not to forewarn Klaassen that they planned to terminate him, because they were concerned about how Klaassen would react

while still having access to Allegro's intellectual property, bank accounts, and employees."

    - The Supreme Court also concluded that one of the defendant directors sent Klaassen a misleading email, the Supreme Court quite understandably began its analysis of the equitable issues in the case by noting that "our courts do not approve the use of deception as a means by which to conduct a Delaware corporation's affairs, and nothing in this Opinion should be read to suggest otherwise."
    - Still, the Supreme Court held that **under equitable principles** the Allegro board's action **was voidable, and not per se void, and that Klaassen's claim would therefore fail because of his acquiescence in the decision.** In the course of so concluding, the Supreme Court overruled any portions of the Koch line of cases that suggests that a board action carried out by means of deception is per se void, not voidable.
    - The disposition of the equitable claim in Klaassen presents an important practice point. As it did with questions concerning the interpretation of the Koch line of cases, on the question whether the deception alleged by Klaassen was enough to potentially void the board's decision to terminate him, the Supreme Court sidestepped the issue ("we need not address the merits of Klaassen's deception claim, because we find...that Klaassen acquiesced").

6. Compliance committees

- A minority of companies, typically companies with intensive regulation and high potential liability for infractions, **maintain a specialized compliance committee that operates separately from the audit committee.**
- **It is also composed usually of a majority of independent directors**.

7. Governance and nominating committees

- **The independence of directors can sometimes be challenged on the ground that even if a director is formally "independent"** of management under applicable definitions of the term, **the intricate network** of friendship, family, business and social ties m**akes it possible for a company's chief executive officer to exercise substantial control over the selection of independent board members** and to influence the decisions these board members make once they join the firm.
- **It is nearly impossible to police against these connections**.
- But the exercise of cronyism and "old school" connections can **be reduced if the job of nominating new directors is taken away from the company's managers and given to unrelated parties**.
    - This is where corporate governance **and nominating committee comes in**.

8. Compensation committee

- Compensation of decision-makers in firms is a central task of governance.
- **One of the principal mechanisms for enhancing the independence of the compensation function is to establish compensation committees staffed by independent directors**.
- The following case reveals how this committee function at Walt Disney Company.
- **Walt Disney Derivative Litigation (District Court Delaware)**

- In re Walt Disney Derivative Litigation, 825 A 2d 275 (Del. Ch. 2003) is a US corporate law case from, concerning the scope of the duty of care under Delaware law.
- Facts:
  - The Walt Disney Company appointed Michael Ovitz as executive president and director.
  - The other members of the committee and the board were not told until the negotiations were well underway.
  - Ovitz insisted his pay would go up if things went well, and an exit package if things did not. It all totaled about $24m a year.
  - Irwin Russell cautioned that the pay was significantly above normal levels and 'will raise very strong criticism.
  - Mr Graef Crystal, a compensation expert warned that Ovitz was getting 'low risk and high return' but the report was not approved by the whole board or the committee.
  - **On 14 August 1995 Eisner released to the press the appointment, before the compensation committee had formally met to discuss it**.
  - Russell, Raymond Watson, Sidney Poitier and Ignacio E. Lozano, Jr. met on 26 September for an hour.
  - Within a year Ovitz lost Eisner's confidence and terminated his contract (though it was certainly not gross negligence). Ovitz walked away with $140m for a year's work. Shareholders brought a derivative suit.
- Judgment:

In re Walt Disney Shareholder Litigation *(Employment agreement)*	Court created new "BF standard" to get around DGCL 102 BF = "*knowing or deliberate indifference to his duties to act with care*" Court found that every member of the board acted with negligence + w/o GF So ⇒ no protection under 102(b)(7). Show of **lack of good faith** standard: *Consciously and intentional disregards or responsibilities. *Knew they did not have enough info. *Knowledge + deliberate indifference. **Conclusion** ⇒ BOD didn't act in GF, so no protection under DGCL 102. (This case is as bad as *Van Gorkom*).

9. **<u>Consultants:</u>**
- **Nearly every large company today uses compensation consultants to advise them on the right way to pay senior executives.**
- Compensation consultants offer three potential benefits to the firms they advise:
  - first they provide **expertise on laws and practices**

- second they haven an **extensive data base of nonpublic information** about compensation practices, which allows them to compare proposed compensation packages with those of similar firms
- third compensation consultants **offer protection against attack** (vindication purpose in front of the public)

- **Criticism**. The problem is that <u>they are paid by their clients and their clients may be under the control of the very executives whose salaries and benefits they are evaluating</u>.

- Compensation consultants for public companies are regulated by **§952 of the Dodd-**Frank Act and implementing SEC regulations. The set of rules provide a set of **factors, which the compensation committee must take into account when selecting a consultant**.

10. <u>The role of shareholders in compensation:</u>

- Today a potent combination of activists, institutional shareholders, and legal changes has significantly altered the balance of power over the issue of executive compensation trimming the discretion of management and increasing the impact of shareholder voice.
- Four provisions in the Dodd-Frank Act are significant (p. 100 – 101).

Executives

1. **Introduction**
   - The board of director can decide on broad issues of strategy and can oversee the operations of the company at a general level, **but board members necessarily rely on the company's senior employees to carry out the practical tasks of management**.
   - **The senior executive team as a whole is sometimes referred to as the "management of the company".** This can be confusing, because under the law the board of directors is ultimately responsible for how the company is managed.
   - **In practice**, however, **senior executives rather than the board make the vast majority of decisions regarding the company's organization and strategies**. The term "management" is an appropriate word for this group of employees.

2. **The management team:**
   - In the case of publicly traded firms one of the management team's most important compliance responsibilities is contained in **§404 of the Sarbanes-Oxley Act (SOX).**
   - **Requires that a reporting company's annual report must contain an internal control report which states the responsibility of management for establishing and maintaining an adequate internal control structure an procedures for financial reporting**. The report must also contain an **assessment of the effectiveness of the internal control structure and procedures** of the issuer for financial reporting. The SEC requires reporting firms **to maintain disclosure controls and procedures and internal control over financial reporting**.
   - **An internal control over financial reporting is a process to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes** in accordance with generally accepted accounting principles and **includes those policies and procedures that**
     - pertain to the **maintenance of records** that in reasonable detail accurately and fairly reflect the transactions and dispositions of the assets of the issuer
     - **provide reasonable assurance that transactions are recorded**
     - **provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition**, use or disposition of the issuer's assets that could have a material effect of the financial statements
   - **Firms often use the "Integrated Framework" for internal control established by the Committee of Sponsoring Organizations of the Treadway Commission** (COSO). A 2013 COSO revision to this framework identifies **five components of internal control:**
     - Control environment
     - Risk assessment
     - Control activities
     - Information and communication
     - Monitoring activities

3. **The chief executive officer:**
   - **He is the senior-most official in a firm**. Technically the **CEO is an employee of the organization**, working under a contract, **reporting to the board of directors** and subject to many of the rules that apply to other employees. In practice however **the CEO**

is more than that. She has many important responsibilities and exercises the power that attends those duties:

- **The CEO is the public face of a firm**.
- **The CEO is ultimately responsible for making decisions at the management level.**
- Most important from the standpoint of compliance the **CEO is responsible for setting the tone at the top**.
- For public companies **CEO's have one other important compliance responsibility**.
    - Section 302 of the Sarbanes Oxley Act (civil provision enforces by the SEC) requires the **CEO and chief financial officer (CFO) to certify in each annual and each quarterly report**
- A related provision is **§906** (is backed by criminal penalties and is enforceable by the Department of Justice).
    - It requires that an issuer's periodic reports to the SEC be accompanied by a written statement of the CEO and CFO.

4. <u>The Chief Financial Officer:</u>

- The CFO is the officer principally **responsible for financial controls and reporting**. In her controller function the **CFO ensures that financial information about the company is compiled processed and presented to the appropriate decision-makers in a timely and accurate fashion**.
- The CFO has **an important role in risk management**. He is responsible for **monitoring the company's financial condition**
- He acts as an economic forecaster, assessing the company's response in the future.
- The CFO is together with the CEO responsible for signing the certifications required under §302 and 906 of the Sarbanes Oxley Act.

5. **<u>The Chief Audit Executive</u>** (head of internal audit):

- **Internal audit: is the function of monitoring the actions of employees, processes and systems to verify their effectiveness and compliance** with internal or external norms.
- The head of internal audit often today **reports to the chief executive officer**, a formal **acknowledgement that the audit function is not subject to the control of any other department in the company**
- At the board level the head of internal audit **reports principally to the board audit committee.**
- To what extent should the internal audit department operate independently form the rest of the company?
    - **the internal audit department is there for purpose of checking up on everyone including even the senior managers**
- **What is the relationship between internal audit and a company's external auditor?**
    - **The external auditor reviews all aspects of a company's financial controls, including internal audit (supervision of internal audit).**
    - internal audit typically cooperates in the performance of the external audit.
        - **How does internal audit work?**

        - The first priority in the internal audit task is to define **what will be audited**. Internal audit deals with **two sorts of auditable components**:
        - A) **functions** such as the company's customer rewards program and
        - B) **entities,** such as say the Atlanta distribution center.
- **the Sum of all auditable components is referred to as the "audit universe"**
- **What components should be in the audit universe?**
    - The audit universe should include everything that can have a tangible effect on the company's fortunes
- **Once the audit universe is determined, the audit department must determine how to fit any particular audit within the overall program**. It must decide, **how frequently** the audit will occur and **how many resources** usually measured in staff time will **be required** when it occurs. **This leads to the preparation of the audit plan**.
- "**The audit plan" is the schedule for the timing and anticipated resource requirements for all audit within the audit universe**.
- Typically the audit plan will be developed after a risk assessment by the internal audit department.
- **The internal audit process assesses whether and to what extent the audited component is performing**
- As the audit progresses **internal auditors assess whether their review and investigation have uncovered any significant failures to satisfy the audit criteria**.
- "**Audit findings" are internal audit's determinations** about whether the relevant audit criteria are being met.
- **What is being done, when internal audits finds that audit criteria are not being met?**
    - Remedial actions.
- **Internal audit reports** usually contain:
    - A statement of any problem identified
    - A statement of the audit criterion or criteria
    - An analysis of the cause of any negative findings
    - A description of the consequences of the problem so identified
    - And a statement of what is being done to remediate the problem or accept the risk or a recommendation about what should be done.
- **Serious findings are being brought to the attention of senior management**. **Critical findings are brought to the attention to the board audit committee**.
- **Vendors: the task of internal audit have increased dramatically in recent years both in magnitude and in complexity**. The job gets more difficult every year. In order to manage their increased responsibilities and to keep costs under control, **internal audit departments have turned to the use of outside vendors**. Vendors are useful for most firms but they can be **particularly helpful for smaller institutions.** Vendors provide the general types of services to internal audit departments:
    - **They may offer vendor-created audit software. This is particularly useful in five key areas:**
        - It provides controls which managers can use to make sure that applicable rules and standards are being followed

        - It can organize work-flow
        - It can maintain documentation
        - It can provide templates in the preparation of required reports
        - it can track changing audit requirements and integrate them
   - **Accordingly vendors provide a valuable service to aid in the internal audit function**.
      - **risks**: the vendor's product may **not perform** as represented or may require **access to proprietary or non-public information** maintained by the client, creating a **risk of data breaches**
   - **The banking agencies' give advice on how internal audit should manage vendors**
      - The agencies want to ensure that arrangements with outsourcing vendors do not leave directors and senior management with the erroneous impression that they have been relieved
      - An outsourcing arrangement is a contract between an institution and an outsourcing vendor to provide internal audit services.
      - Some outsourcing arrangements are structured so that an outsourcing vendor performs virtually all the procedures or tests of the system of internal control.
      - **Even when outsourcing vendors provide internal audit services the board of directors and senior management of an institution are responsible**
   - Institution should perform due diligence to satisfy itself that the outsourcing vendor has sufficient staff qualified to perform the contracted work.
   - **Management**: Directors and senior management **should ensure that the outsourced internal audit function is competently managed.**
   - **Communication**: communication between the internal audit function and the audit committee and the senior management **should not diminish** because the institution engages an outsourcing vendor.
   - Contingency planning: When an institution enters into an outsourcing arrangement it may increase operational risk. **Because the arrangement may be terminated suddenly, the institution should have a contingency plan to mitigate any significant discontinuity** in audit coverage, particularly high-risk areas.

6. **Chief Compliance Officer**: Some companies vest the **compliance function in a special office headed by a senior executive officer** sometimes referred to as the chief compliance officer (CCO)
   - CCO's tasks are the followings:
      - He **oversees the corporate compliance program functioning**.
      - **The position ensures the board of directors management and associates are in compliance with the rules and regulations of regulatory agencies**.
      - **He acts as staff to the CEO and board of directors corporate compliance committee by monitoring and reporting results of the compliance**

7. **General Counsel:** Traditionally **the general counsel was in effect the company's compliance officer.** In some companies they continue to perform that function. In **many firms however, their responsibility for compliance has been curtailed, although they continue to play an important role in other respects.**

- The reason for this is that the job of compliance **is no longer exclusively a legal task.**
- A modern compliance operation cannot be staffed exclusively by lawyers.
- **Nowadays the general counsel is the company's lawyer.**
- **If legal violations are detected the general counsel will usually have input in devising the company's response**.
- The general counsel is likely to have significant input into the company's assessment of reputational risks.

8. **Chief Risk Officer:** Many companies host a **chief risk officer (CRO) in a senior management position.**
    - The CRO where one exists is charged with **designing and implementing risk management policies and procedures across the organization**.
    - He reports to the chief executive officer the chief financial officer or to the board or the board risk committee.
    - The position of CRO has grown up along with **the increasing importance of enterprise risk management strategies** that seek to coordinate risk across the entire organization.

9. **Profs. Up-date:**
    - In the matter of ***Edward L. Cummings, CPA,*** **SEC Administrative Proceeding (2014)**
        - SEC alleged that on numerous occasions **Cummings, an accountant and chief financial officer (CFO) of a failed reporting firm**, had receivable and inventory received with a view toward improving the firm's access to credit markets.
        - **SEC alleged that Cummings had falsely represented that he and the other certifying officer had been responsible for establishing and maintaining the company's internal controls over financial reporting and had falsely certified** that he and the other officer **had disclosed all significant deficiencies** in internal controls to the company's independent auditor.
        - **Even thought the misconduct of Cummings was minor he was given a significant penalty by the SEC.**
        - The SEC probably wanted to signal that even small offenses would not be tolerated.

INTRODUCTION TO COMPLIANCE

A. WHAT IS COMPLIANCE?

The compliance function is a form of internalized norm enforcement within organizations.

Elements:

- An actor that conforms behavior to some standard or norm
- Standard or norm is external [not set by actor, rather by some authority]
- **Actor not necessarily acts in accordance with the standard. Some effort, will, incentive or compulsion is involved**.

Additional elements for purposes of this course:

- **Actor: complex organization**, not an individual
- Referred **not only to the organization's behavior in conforming to the norm**; but to the actions that the organization undertakes to ensure that the norm is obeyed.

Compliance involves a tradeoff of costs and benefits:

- **The organization, as opposed to an external norm enforcer, has the knowledge and the ability to perform compliance tasks much more effectively than an outside party**. It makes sense for institutions to police themselves to carry out a compliance operation.
- Nonetheless, **an external enforcer needs to monitor the compliance** function to ensure that it is faithfully and effectively carried out.
- **Problem of costs:**
    - o When external enforcer operates directly the compliance function, rather than through a compliance operation, **the enforcer bears all the costs**.
    - o **When the external enforcer relies on internal compliance to enforce norms, the enforcer does not bear the costs of enforcement; they are imposed on the organization.** In this case it may **demand to the organization to implement compliance operations more costly and not effective or necessary**.

B. BACKGROUND AND ORIGINS OF COMPLIANCE

- The *Interstate Commerce Commission*: Federal Administrative Agency created by the Interstate Commerce Act of 1887 to regulate the railroads.
- *Progressive Movement of the 1890s and 1920s*: Concern for eliminating corruption and enhancing efficiency government. [Achievements: Pure Food Drug Act (1906), Federal Reserve Act (1913) and the Clayton Antitrust Law (1914).
- *Depression and the New Deal of the 1930s*: Fundamental Reforms of the financial system [Banking Act 1933 and the Securities Act of 1933 and 1934].
- *Environmental Awareness*: 1960s. Implementation of Federal Statues [Clean Water Act and the Clean Air Act, Environmental Protection Agency]
- *Enactment of Foreign Corrupt Practices Act 1977*
- *Savings and Loan Debacle 1979:* Significant legislation that upgraded banking regulation.

- *Corporate Scandals of 2000s [Enron, WorldCom, Global Crossing and Adelphia]:* Led to enactment of Sarbanes – Oxley Act (2002), one of the most important governance and compliance statutes in American history.
- *Terror and rogue states [September 9/11]:* Enhanced the obligation of financial institutions to report suspicious activities, set of sanctions imposed on governments deemed not to be in compliance with the obligations of international law. Regulations that are very complex and troublesome for compliance today.
- *Financial crisis 2007* – 2009: Real-estate crisis gave rise to the Dodd- Frank Act (2010) that contains many provisions of compliance, being the most significant piece of financial regulation since the Great Depression.

C. THE RISE OF THE ADMINISTRATIVE STATE

- During the 19th Century: the authority of the government to regulate private organizations followed a **judicial model of regulation**.
    - The government and the regulated organization were seen as parties on equal footing.
    - To obtain relief, the government had to go to court and establish its case under the applicable standard of proof.
    - Complex regulatory statues did not exist.
    - Governing rules were those of the Common Law.
    - If the applicable principles were statutory it was the courts, not the government, that gave meaning and content to the ambiguous provisions.
    - Criminal enforcement against organizations was unknown. Penalties enforced were not exorbitant.

- Nowadays the **administrative model of regulation** is followed.
    - Legal norms governing complex organizations are defined, adjudicated and **enforced by administrative agencies rather than courts**.
    - **Judges are not absent from the process, but play a decidedly less important role** than in the past years.

Three important aspects of the transition from the **judicial model to the administrative model:**

1. Increases in the extent and **complexity of the model**;
2. **Displacement of courts from their traditional role** in defining and adjudicating legal rights and
3. **Increases in the government's enforcement powers**.

1. Increases in the Scope and Complexity of Regulation

Growth in the scope and complexity of regulation in 3 phases:

- ***Progressive Era*:** Congress imposed federal regulations on anticompetitive conduct, foods, drugs and the railroad industry.
- ***New Deal*:** Congress Regulated Banks, Securities Firms and Financial Markets
- ***Period 1960's – Today*:** The general trend is that Congress and state legislatures impose more complicated and more comprehensive regulations over an ever-increasing domain of private activity.

2. From Judging to Administration

a. Power to establish Norms of Conduct:

- Before substantive rules were provided largely by judges
- **Today substantive rules are provided largely by legislatures and administrative agencies**
- Transformation fiercely resisted by judges
- Efforts at judicial resistance largely ended during the New Deal of the 1930s

SEC v. Chenery Corp. *332 U.S. 194 (1947)* **This case is a landmark in the transition from the judicial to the administrative model of enforcement,**	• **SEC held, based on judicial precedent, that managers of a public utility in reorganization could not convert preferred stock** they owned in the company into stock of the reorganized company. • 1934: **Supreme Court rejected the agency's decision on the ground that it was not supported by the cited judicial authority**. • Redemand**: SEC reached the same decision supported now by public policy arguments, rather than case law.** [Comments: The SEC simply gave up on citing judicial precedents and supported the same decision with free floating policy rationales] • Five years later: Court upheld the agency's decision	• "[…] Judgment based upon public policy, a judgment which Congress has indicated is of the type of the Commission to make…Whether we agree or disagree with the result reached, it is an allowable judgment which we cannot disturb". • Dissent: "The Court sustains the identical administrative order which recently had held invalid….It makes judicial review of administrative orders a hopeless formality for the litigant….The Court of Appeals is obliged to defer to administrative experience and to sustain a Commission's power merely because it has been asserted and exercised, of what use is it to print a record or briefs in the case, or to hear an argument? Administrative experience is always present, at least to the degree it is here, and would always dictate a like deference by this Court…." • Justice Jackson [dissent]: Bemoans the loss of judicial power implied by the move to the administrative model of regulation. "…an administrative agency is not a law unto itself". • Justice Murphy [View that PREVAILED]: "The Commission's conclusion here rests squarely in that area where administrative judgments are entitled to the greatest amount of weight my appellate courts. It is the product of administrative experience, appreciation of the complexities of the problem, realization of the statutory policies and responsible treatment of the uncontested facts. It is the type of judgment which administrative agencies are best equipped to make and which justifies the use of

- **Over time courts came to accept that not only legislatures, but also administrative agencies could establish norms of conduct that differed substantially from the norms traditionally enforced under principles of equity or the common law**.
- The administrative Procedure Act (1946) recognized and confirmed that federal agencies **can determine private rights and obligations**, either by way of formal rulemaking procedure or through case by case determination.
- Agencies came to enjoy substantial powers in the interpretation of governing norms.
- **Judicial role in interpretation of the norm is trumped by the <u>Chevron doctrine</u>:**

Chevron v. Natural Resources Defense Council, 467 U.S. 837, 843 (1984)	• **Requires courts to defer to agency interpretations:** • **When a court reviews an agency's construction of the statute which it administers, it is confronted with two questions**. • First, **whether Congress has addressed the question at issue**. • If the **<u>intent of Congress is clear</u>, that is the end of the matter for the court and the agency**. Both must give effect to the UNAMBIGUOUSLY expressed intent of Congress. • **If the intent of Congress is not clear and therefore the statute is reasonably susceptible to several meanings, one of which is adopted by the agency charged with its implementation, the <u>COURT SHOULD DEFER TO THE AGENCY'S INTERPRETATION</u>** event if the court on its own might prefer a different interpretation.

National Cable & Telecommunications Association v. Brand X Internet Services *545 U.S. 967 (2005)* **This case explores outer reaches of the Chevron Doctrine.**	• In September 2000 **the Federal Communications Commission (FCC) initiated a rulemaking proceeding to classify the type of services that companies that offered broadband Internet Services provided to consumers.** • In the Declaratory Ruling the Commission concluded that **broadband Internet service provided by cable companies is an "information service" but not a "telecommunication service" under the Communications Act.** • The Court of Appeals held that the Commission could not construe the Communications Act to exempt companies from regulation, grounding its holding in the *stare decisis* effect of a previous decision and overrode the interpretation reached by the Commission. • Rationale of the Court of Appeals: Assumption that the precedent cited overrode the Commission's interpretation, regardless of whether the precedent had held the statute unambiguous. Previous reasoning was <u>INCORRECT</u>. • **Supreme Court upheld FCC's interpretation.**	• *Holding*: **A Court's prior judicial construction of a statute trumps an agency construction otherwise entitled to Chevron deference only if the prior court decision holds that its construction follows from the unambiguous terms of the statue and this leaves no room for agency discretion**. • *Reasoning*: **Chevron established a presumption that Congress, when left ambiguity in a statute meant for implementation first and foremost by an agency** (rather than the courts). • Chevron's premise is that **it is for agencies not courts to fill statutory gaps**. • **Only a judicial precedent holding that the statute unambiguously forecloses the agency's interpretation,** and therefore contains no gap for the agency to fill, displaces a conflicting agency interpretation. • Dissent: Judicial decisions are subject to reversal by the executive officers.

City of Arlington v. F.C.C. *133 S. Ct. 1863 (2013)*	• **The question in this case is whether a court must defer under Chevron to an agency's interpretation of a statutory ambiguity that concerns the scope of the agency's statutory jurisdiction**. • **The majority decided that Chevron applied** and that jurisdictional and non-jurisdictional differences should not be made. • Dissent: Authority of administrative agencies should not be augmented to include not only broad power to give definitive answers to questions left to them by Congress, but also the same power to decide when do they have jurisdiction.

b. **Power to determine Legal Rights:**

Obstacles to giving the administrative agencies the power to issue binding compliance orders:

- ***Due Process Clauses of Fifth and Fourteenth Amendment*: Whether due process could be satisfied if a party is brought before an administrative agency rather than a court.**
- *Seventh Amendment*: Federal Court litigants **right to a trial by jury**.

- *Article III of the Constitution*: **Structural requirements for judges [not term-limited, salaries, nominated]**

Cases authorizing administrative agencies to adjudicate legal rights in compliance cases.

Crowell v. Benson *285 U.S. 22 (1932)* This case dealt with 2 constitutional objections to administrative tribunals: The Due Process Clause and the requirements for federal courts under Article III of the Constitution.	• An administrative agency, the United States Employees' Compensation Commission, administered the Harbor Workers' Compensation Act of 1927. • **Claims for compensation were filed with a deputy commissioner who had full authority to hear and determine all questions in respect of the claim, without being bound by conventional rules of evidence or formal procedures.**	• *Holding*: Present case is an exception to Murray's Lessee v. Hoboken Land & Improvement, since this case concerns the determination of public rights, being the liability of one individual to another under the law. • *Reasoning:* **Utility and convenience because it is prompt. continuous, expert and inexpensive method for dealing with a class of questions of fact. which administrative agencies are suited to examine and determine.** • **The Court also recognizes certain limitations. The same due process protections that would apply in court proceedings apply in the administrative tribunal** [notice and opportunity to be heard, decision based on evidence]. • **Agency findings of jurisdictional fact are subject to de novo review in federal court.** • [Comment: International Shoe Co. v. Washington, 326 U.S. 310 (1945) gave also broad authority for <u>state regulators</u> to issue binding legal judgments.

Atlas Roofing Co. Inc. v. Occupational Safety and Health Review Commission *430 U.S. 442 (1977)* **This case dealt with the Jury Trial under the Seventh Amendment.**	• The Occupational Safety and Health Act of 1970 **empowered the Occupational Safety and Health Review Commission to impose civil penalties and abatement orders on employers who fail to provide safe working conditions.** • If an employer contests and order an administrative law **judge of the Commission conducts a hearing and is empowered to affirm, modify or vacate the proposed abatement order and penalty.**	• *Holding:* When Congress creates new statutory "public rights", **it may assign their adjudication to an administrative agency, without violating the Seventh Amendment** [right to the Jury Trial] • *Reasoning:* **The Seventh Amendment never was intended to establish the jury as the exclusive mechanism for fact finding in civil cases**.

Camp v. Pits *411 U.S. 138 (1973)* Even when the initial authority to adjudicate legal rights is vested in an administrative agency, disappointed parties typically have a right to challenge the administrative action in court. This case determines to what extent. It illustrates how parties must overcome high and sometimes insuperable obstacles to obtain relief in court.	• 1967 **Respondents submitted an application to the Comptroller of the Currency for a certificate authorizing them to organize a new bank.** • The Authority **denied the application** • Respondents asked for **reconsideration.** • Again Authority **denied the application** • Respondents filed an action in federal district court seeking review of the Comptroller's decision. • **The Court granted summary judgment against respondents and decided that the decision was not capricious nor arbitrary**. • **Court of Appeals held that the Comptroller's ruling was unacceptable because its basis were not sufficiently clear** to permit judicial review. • The case held that it should be remanded "for a trial de novo before the District Court".	• Holding: **The Comptroller's action is subject to judicial review under the Administrative Procedure Act (APA), 5 U.S.C. §701.** It is clear that neither the National Bank Act nor the APA requires the Comptroller to hold a hearing or to make formal findings on the hearing record when passing on applications for new banking authorities. • **Appropriate standard for review: Whether the Comptroller's adjudication was "arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with the law. It does not extend to conduct a de novo trial, no matter how feckless the decision is.** • In applying the standard the focal point for judicial review should be the administrative record already in existence, not a new record made by the reviewing court. • The Comptroller's decision provided a substantial basis that was sufficient.

Ex Parte Young *209 U.S. 123 (1908)* The problem in this case can be avoided if the regulated party is afforded some means to obtain a determination of its rights prior to engaging in the forbidden conduct. [i.e. temporary restraining order or preliminary injunction]	• **Minnesota laws and administrative regulation slashed the rates that railroads could charge customers in the state. Violators were subject to heavy and civil penalties.**	• Holding: **A provision is unconstitutional when the penalties for disobedience are by fines so enormous and imprisonment to severe as to intimidate the company and its offers from resorting to the courts to test the validity of the legislation, the result is the same as if the law in terms prohibited the company from seeking judicial construction of laws that affect their rights.** • The previous rule **has been narrowed to sanctions that are severe.** • The previous rule does not apply if the party can avoid the sanction by interposing a good faith challenge to the enforcement action.

3. Enforcement Powers

a. Power to obtain information

- **Government regulators enjoy broad rights of access to information about the affairs of business firms.**

  Examples: (i) Any company that wants to **list its securities on a public exchange must make full disclosure of its operations**, financial performance and governance arrangements; (ii) Companies that need government licenses **must provide the licensing agency with information as a precondition to obtain it**; (iii) Industries such as banking, insurance, mining, pharmaceutical or nuclear power **must submit to inspections of**

compliance, (iv) tax authorities require elaborate disclosure of a company's income and expenses.

- **Companies are protected by the Bill of Rights. The Fourth Amendment prohibits unreasonable searches and seizures**.

Case that explores the scope of a company's Fourth Amendment rights.

Donovan v. Dewey *452 U.S. 594 (1981)*	• **The Federal Mine Safety and Health Act of 1977 provides that federal mine inspectors are to inspect, without advance notice, mines to insure they comply with standards provided by the law and to make follow up inspections to determine whether previously discovered violations have been corrected.** • In July 1978 a federal mine inspector attempted to inspect quarries and determine whether some prior detected violations had been corrected. • **The President of the Company denied the inspection without a warrant.** • The Secretary subsequently filed this civil action seeking to enjoin appellees from refusing to permit warrantless inspections	• *Holding*: **The warrantless inspections in this case required by the Mine Safety and Health Act do not offend the Fourth Amendment.** • *Reasoning*: **Unlike searches of private homes, legislative schemes authorizing warrantless administrative searches of commercial property do not necessarily violate the Fourth Amendment.** • Rather the Fourth Amendment protects the interest of the owner of the property in being free from unreasonable intrusions onto his property by agents of the government. • Unreasonable: If they are not authorized by the law or are unnecessary for the furtherance of federal interests. • **Policy in this case: Compelling interest in ensuring safety of workers in mines and the Court suggests that if the mine operator is tipped off with the inspection it can disguise evidence of infractions and frustrate the purpose of the program.**

b. Power to impose penalties.

- **Key aspect of agency enforcement powers: Sanctions they can threaten against regulated entities who violate applicable norms or resist enforcement efforts.**
- Civil sanctions and criminal penalties.
- **Criminal prosecutions for failure of compliance** were rare before the late 1980s. From the 1990s until today there has been a trend in pursue criminal prosecutions for failure of compliance.
- Prosecutors may charge industry-specific crimes and a variety of general federal offenses.

Arguments that a defendant charged with civil or criminal violations of regulatory statutes may allege [However, in the majority of the cases, the penalties CAN be legally imposed]:

- **If penalty scheme is irrational** – it bears no credible relationship with any of the statutory purposes – **A court might declare that imposing a sanction would violate principles of substantive due process**. However, if it shows a minimal core of rationality it survives this lenient standard.
- **Excessive fines clause of the Eighth Amendment**: To prevail a party must establish that the regulatory action was punitive and that the penalties are grossly disproportionate to the gravity of the alleged offense.
- A court might elect to interpret an ambiguous statute in an effort to avoid constitutional issues.
- **In criminal ases, the defendant is entitled to have a jury determine beyond a reasonable doubt any fact that increases the penalty for a crime beyond the statutory minimum**.

Theories that may explain **why the vigor of enforcement and the severity of penalties increased over the past decades**:

- **Move towards the administrative model** of enforcement corresponds to changes in public attitudes and corresponding shifts in political power. Once the public trusted the firms and organizations.
- **Greatly increased threats to public welfare posed by business enterprises** (banks, securities firms, pharmaceutical companies and energy companies).
    - **Business are larger, more sophisticated and more interconnected**, the systematic risk that create to the public welfare increased.
- **Regulators have limited budgets and large responsibilities. Move from judicial to administrative role is a rational response to that problem**. Now it is easier and cheaper to detect violations and enforce the rules.

D. THE COMPLIANCE RESPONSE

- **Pace of enforcement is accelerating**
- (i) Transformation **from judicial to administrative model** plus (ii) Enormous **upgrade in regulatory power** that accompanied the transformation = growth of the compliance function over the decades.

E. THE COMPLIANCE INDUSTRY

- **Increase in the size and importance of compliance departments**.
- **Creation of jobs**
- Professional **training** in compliance
- New Profession: Compliance officer = combines elements of existing professions (law, accounting, business, management science) but adds something of its own.

Internal Enforcement

A. Introduction

Internal enforcement is a way in which the compliance function is carried out.

B. Compliance Policies

- **Definition: Statement approved by the highest-level authority in an organization that sets forth the organization's philosophy and general approach to compliance issues**.
- **Management must demonstrate to the workforce and others that the company is truly committed to compliance at the highest level. "Tone at the top" –** a set of values and standards subscribed by the organization's leaders and communicated throughout the organization.
- Company may **also show commitment by (i) appointing high-level officer to head compliance** and give that person the necessary resources and access to decision makers, and (ii) **responding swiftly to compliance violations**.

Rhetoric is also important. Colloquial tone is more effective than legalese. E.G. Google's "Don't be evil".

C. Compliance Programs

- **Definition: Formal statement of mechanisms that an organization uses to ensure compliance, and procedures to employ when non-compliance is discovered**.
- Law does not require compliance policies. No legal liability for failure to adopt one.

D. Hiring

- **The selection of the people who work for an organization is crucial.** Most important are the senior staff (especially those involved in the three lines of defense), but lower-level employees can have an impact on compliance too.

1. Background investigations

- **Background investigations are legal so long as no deception is used and the investigation does not intrude on information deemed to be private under the law.**
- **Some types of information may not be requested at all by the potential employer** (even with the candidate's consent), **such as medical records** (although employer can ask if candidate has a medical condition that may interfere with performance of job). Also, **employer cannot ask about race, age, gender, disability or other protected category**.

2. Use of Information

- What use can the employer make of information once obtained?

a) Arrests and convictions

  - In favor of use - actions a person has performed are **predictive of what she may do** in the future, to some extent.
  - **Against use (or in favor of moderate use**) – Society might be better off if a person with the right skills is matched with a job, **regardless of her history.**
  - **Equal Employment Opportunity Commission (EEOC)** – **"Using such records as an absolute measure to prevent an individual being hired could limit the employment opportunities of some protected groups"**. These records should be **used only to the extent that it is evident that the applicant cannot be trusted to perform the duties** of the position when considering (i) the **nature of the job**, (ii) the **seriousness of the offense**, and (iii) the **time since it occurred**.

  - EEOC filed lawsuits **against 2 employers for use of criminal background checks**

- **BMW** – Uti, a logistic services provider to BMW, assigned workers to work at the BMW facility. UTi screened the employees according to UTi's criminal conviction policy, which limited review to convictions within the prior 7 years. BMW's policy had no time limit. The policy is a blanket exclusion without any individualized assessment of the gravity of the crimes, the ages of the convictions or the nature of the claimant's positions.
- **Dollar General** – Dollar General conditioned all job offers on criminal background checks, resulting in a disparate impact against African Americans (Two cases: (i) job offer revoked after disclosing conviction for possession of controlled substances despite applicant had previously worked for 4 years at another retail store, and (ii) conviction records check report on employee was wrong but Dollar General did not reverse its decision to fire her).

b) Credit history

- **The fact that a person has experienced financial distress is potentially relevant to their performance on the job.** On the other hand, inquiry into a person's financial history **is intrusive on their privacy**.
- **Reports may not be provided unless applicant provides written authorization**.

E. Training

Should reflect the nature of job. Training is particularly important for companies that employ many lower-level employees whose activities may implicate compliance concerns.

F. Monitoring

A key part of internal enforcement is the job of **monitoring employees**. There is always a tradeoff between efficacy and privacy. **Unless a firm monitors employee's compliance with norms, firms will detect fewer violations; and because they detect fewer violations, more violations are likely to occur**. On the other hand, monitoring raises serious concerns of employee privacy.

1. Drug and Alcohol Testing

Dr**ug testing by public officials is regulated by law** (e.g. Fourth Amendment's prohibition of unreasonable searches and seizures). Conversely, **private firms are not subject to such restrictions**. Unless the employment agreement or union contract specifically provides limits, there are **practically no limits under the law** as to these kinds of tests by employers.

2. Surveillance

- **Employers may also conduct surveillance activities on employees** (reviewing telephone logs, surveillance videos, analyzing keystrokes on their computers, emails, etc.) to a very large extent.
- Law generally prohibits recording telephone calls and other conversations. But this protection of privacy doesn't necessarily apply in the workplace.

- **Can an employer rifle through an employee's possessions stored at her work desk? Generally yes if the desk is in a public space.** If lockers are provided to employees these are likely to be considered private space, which the employer may not enter.
- Although employees have little legal protections concerning their privacy at work, **employers must trade-off its interest in ensuring compliance and preventing employee misconduct, on the one hand, and its interest in having a happy and satisfied labor force.**

G. Investigations

1. Types of Investigations

- **Small-scale inquiries into minor misconduct**

    - Usually performed **in-house by Human Resources**.
    - Many companies have standardized procedures in place, which may include stepped-up surveillance.
    - Typically the company w**ill only call the suspected employee once enough facts are uncovered** to warrant a conclusion as to what to do.
    - **No formal requirement to alert the authorities if criminal behavior is uncovered**. Company must analyze what **it wants to recover and the potential disruption caused by alerting the authorities**. Company should also analyze **whether it may face liability for not alerting if suspect then harms someone else**.
    - Usually kept confidential.

- **Large-scale investigations**
    - **Cannot be performed in-house.**
    - Company **must hire experts to make the investigation credible**. This may be expensive. To give more credibility the scope of the investigation must not be limited for the external investigator.
    - **Often expected that these investigations will be disclosed (at least when concluded). Early disclosure might be good to dissipate rumors and demonstrate a firm's commitment to complianc**e. However, early disclosure can **lead to witnesses becoming adversarial** and may give the suspected individual a chance to rehearse their stories.
    - **Investigation will likely be conducted under the shadow of government enforcement actions.**

2. <u>Miriam Hechler Baer, Corporate Policing and Corporate Governance: What Can We Learn from Hewlett Packard's Pretexting Scandal?</u>

- HP**, through a non-executive Chairperson, initiated an investigation to identify the source of a leak of confidential information known as Project Kona I**I.

- The investigation featured:

    - Reviewing the **company email accounts**, phone records and computer hard drives of every member of the executive council
    - **Hiring a private investigation** firm that subcontracted the job of obtaining private telephone records of Board members and journalists, including Kawamoto the reporter who had written the article
    - Following Kawamoto and Board members in public
    - Setting up a sting in which they sent an email to Kowamoto with tips about HP and an attachment whose **tracking software** would trace the email's path after it left Kawamoto's computer.

    - **The investigation was monitored by HP's chief compliance officer who reported to HP's general counsel.**
    - After the investigators identified **George Keyworth as the source of the leak**
    - Prior to the Board's meeting, the chair of the Board's Audit Committee disclosed the identity of the source during the Board's subsequent meeting.
    - During the Board's deliberations to decide whether Keyworth should be asked to resign
    - **Perkins, one of the Board members, stormed out and announced his resignation**.
    - Perkins discussed with HP's outside counsel: (a) the **manner by which HP had conducted the investigation**, (b) the investigators' attempts to obtain information regarding Perkins' personal phone line, and (c) HP's obligation to disclose Perkins' reasons for leaving HP. As a result of the protests by Perkins,
    - HP's investigation became public and HP's tactics triggered inquiries by Congress, the SEC and simultaneous state and federal criminal investigations.

3. **Comparison of Internal Investigations and Government Investigations**

- **Both seek the same objective (ferret out evidence of legal violations within the organization).**
- Differences in terms of effectiveness
- **Gov't investigations have access to powers of compulsory process**.
    - **Subpoena allows agencies to compel the production of evidence**
    - **search warrants** allows agents to enter a workplace or an employee's home and take away evidence.
    - The government also benefits from the law making it a **crime to lie to a federal official.**
- On the other hand, **private firms have certain advantages**.
    - Employees have **low expectations of privacy in the workplace**.
    - Employers **do not need subpoena or warrants to investigate** an employee's activities at the workplace. Also, Fifth Amendment protections (Miranda rights + no self-incrimination) are absent in interrogations for internal investigations.

- Differences from the employee's standpoint
    - **No one wants to be pursued by the Gov't** (enormous reserves of penalties and power to compel production of evidence).
    - The most an employer can do is fire you and harm your chances of getting another job (you can't go to prison).
    - However, after an internal investigation is conducted the employer will often turn over its findings to the Gov't.

4. The Role of Counsel

- **Three advantages of having internal compliance investigations spearheaded by counsel:**

    - **Notes, mental impressions, drafts and legal theories prepared by or under the direction of an attorney are likely to be protected**
    - Attorney's professional training and expertise make her a good candidate.
    - Status of attorney will carry a degree of gravitas, **making it more likely that the investigation will be conducted more quickly and with a better response within the organization**.

Chapter 9
REGULATORS
(up to page 221)

Regulators employ several strategies to push organizations to implement robust compliance policies and programs.
The impost important include: **regulatory requirements, settlements of enforcement** actions, **oversight liability**, the granting of **credit or leniency in sanctions**, and **offering advice and guidance** on how to develop an effective program.

programs reduce incidence of violations, since we want to deter violations, compliance programs should be encouraged.

However, **policies to encourage compliance have costs**, including:
- a pretentious compliance program which accomplishes little.
- Getting credit for a compliance program will tend to produce undesirable levels of harm-producing activity.
- **Gov't may need to expend resources to monitor the organization's compliance**.
- <u>Gov't may make mistakes in specifying the criteria.</u>
- When the Gov't makes errors, it will likely require that **regulated parties expend too many rather than to few resources**.

Benefits, as follows:
- Gov't may not be able to impose penalties large enough to incentivize organizations to implement robust compliance programs.
- Companies don't always behave rationally. **Managers may be focused on other things, or may lack the vision** to understand that compliance programs may benefit the company and shareholders.
- Companies that implement bona fide compliance programs demonstrate that they wish to avoid violating legal norms.
- **If companies are risk adverse, there could be an advantage in allowing them to "purchase" insurance policy against risk by expending resources to create a robust compliance operation**.
- Compliance programs can arguably provide external benefits that go beyond the particular rules being enforced.

A. Government –Mandated Compliance Operations

Sometimes the Gov't requires companies **to maintain compliance operations. E.g. with money laundering.**

<u>**Bank Secrecy Act – 31 U.S.C. 5318(h)**</u>

In order to guard against money laundering through financial institutions, each financial institutions shall **establish anti-money laundering programs, including**
- The development of **internal policies**, **procedures and controls**

- The **designation of a compliance officer**;
- An **Ongoing employee training program**; and
- An **independent audit function to test the program**

<u>Securities and Exchange Commission Final Rule: Compliance Programs of Investment Companies and Investment Advisers</u>

Investment Advisers

Investment advisers may not provide investment advice unless the adviser has adopted and implemented written procedures reasonably designed to prevent violation of the Advisers Act. Advisers' policies and procedures should **address the following issues** at a minimum:

- **Portfolio management processes**
- **Trading practices**
- Proprietary trading of the adviser and personal trading activities of supervised persons
- Accuracy of disclosures made to investors, clients and regulators
- Safeguarding of client assets from conversion or inappropriate use by advisory personnel
- Accurate creation of required **records and their maintenance** in a way that secures them from unauthorized alteration
- Marketing advisory services
- Processes to value client holdings and asses fees based on those valuations
- Safeguards for the privacy protection of client records
- Business continuity plans

Investment Companies

Rule 38a-1 **requires fund boards to adopt written policies** and procedures reasonably designed to prevent the fund from violating federal securities laws.

Chief Compliance Officer

Rule 206(4)-7 requires each adviser registered with the Commission to designate a chief compliance officer to administer its compliance policies and procedures.

Likewise, **Rule 38a-1 requires each fund to appoint a chief compliance officer** who is responsible for administering the fund's policies and procedures approved by the board under the rule. **A fund's CCO should be competent and knowledgeable regarding the federal securities laws and should be empowered with full responsibility and authority to develop and enforce appropriate policies** and procedures for the fund. **The CCO will report directly to the BoD**, and it will meet in executive session with the independent directors at least once a year. Finally, Rule 38a-1 added a provision to protect the CCO from undue influence by fund service providers seeking to conceal their o other's non-compliance with securities laws.

<u>Securities and Exchange Commission – In the Matter of Carl D. Johns</u>

Carl D. Johns was employed by Boulder Investment Advisors (BIA) as assistant portfolio manager. BIA and Rocky Mountain Advisers (RMA and jointly with BIA the Advisers) assisted in the management of portfolios for several investment companies. While employed by the Advisers Johns engaged **in active personal trading from 2006 through 2010**, including many securities of companies held or to be acquired by the Boulder Funds.

Johns was required to file quarterly reports on his personal transactions under Rule 17j-1(d) of the Investment Company Act **and annual reports of his holdings**.

Johns submitted **false quarterly reports and annual reports**, failed to pre-clear his transactions and **falsely certified his compliance with the Code of Ethics**.

Rule 38a-1(c) under the Investment Company Act prohibits an officer, director or employee of a fund, or its investment adviser from taking action to coerce, manipulate, mislead or fraudulently influence the CCO in performance of his duties. **Therefore, Johns willfully violated Rule 38a-1(c).**

The Commission therefore **ordered that:**

- Johns **cease and desist from causing any violation** of Section 17(j) and Rules 17(j)-1 and Rule 38a-1(c) of the Investment Company Act.
- Johns **be barred from the association with any broker, dealer, investment adviser**
- Any reapplication for association by Johns will be subject to applicable laws and regulations and may be conditioned by a number of factors
- Johns pay a **disgorgement of profits of $231,169, prejudgement interest of $23,889 and a civil penalty of $100,000 to the United States Treasury**.

B. Compliance Terms in Settlements

In many cases the Gov't demands companies upgrade or implement compliance programs during settlement negotiations over civil or criminal enforcement actions. The following is an example

Dept. Of Treasury (Comptroller of the Currency) – RBS Citizens, N.A.

RBS Citizens had engaged in deceptive practices in violation of the Federal Trade Commission Act. The relevant part of the cease and desist order is as follows:

- Within 10 days the **Board shall appoint a Compliance Committee** of at least 3 independent directors, which may not be employees or officers of the Bank
- **The Compliance Committee shall meet at least monthly and shall submit a quarterly written report to the Board**. The Board shall forward a copy of the report with its comments to the Examiner-in-Charge.

Dept. Of Treasury (Comptroller of the Currency) – **HSBC Bank USA, N.A**.

The Comptroller identified certain **unsafe or unsound practices related to enterprise-wide compliance at HSBC**.

The Comptroller therefore **ordered that**:

- The Board shall maintain a **Compliance Committee with at least 3 directors, of which 2 may not be employees or officers of the bank**.
- Compliance Committee shall **meet at least monthly**
- Within 90 days, the Compliance Committee shall submit a written report to the Board. The Board shall forward a copy of the report with its comments to the Deputy Comptroller and Examiner-in-Charge.
- Within 90 days, the Board or a designated committee of the Board shall adopt a, implement and ensure adherence to a **written enterprise-wide compliance program**

United States v. International Brotherhood of Teamsters, Chauffeurs, Warehousemen and Helpers of America, AFL-CIO et al.

Union defendants acknowledge that **there have been allegations, sworn testimony and judicial findings of pas problems with La Cosa Nostra corruption of various elements of the IBT**.

The court ordered:

1. Injunction
IBT be permanently enjoined from committing acts of racketeering activity

2. Court Appointed Officers
Court shall appoint 3 officers (Independent Administrator, Investigations Officer, and Election Officer).

Independent Administrator

- Shall have the power as IBT's General President and /or General Executive Board under IBT's Constitution
- Shall have the authority to veto actions or proposed actions (including expenditures, contracts and appointments) that may constitute acts of racketeering.

Investigations Officer

- Shall have the **authority to investigate the operation of the IBT** or any of its affiliates, and cause to initiate disciplinary charges against any officer member or employee of IBT, and to institute trusteeship proceedings
- **Shall have the authority to take reasonable steps** to be informed about the activities of IBT (examine books and records, attend meetings of the General Executive Board.)

Elections Officer

- **Shall supervise the IBT elections, the balloting process and certify election results.**

2. Independent Review Board

An independent review board shall be established and shall be made up of 3 members appointed by the Attorney General of the United States and IBT jointly. The independent review board shall have the authority **to hire staff to investigate adequately**: (i) any allegation of corruption**, including bribery, embezzlement or extortion**, or (ii) any **allegation of domination or control or influence of any IBT affiliated member of La Cosa Nostra.**

Upon completion the independent review board shall issue a written report detailing its findings, charges and recommendations.

IBT shall pay for all costs and expenses of the independent review board and its staff.

C. Oversight Liability

Governments do not ordinarily sue for a failure to exercise oversight the company's compliance programs, but here are some examples.

Securities and Exchange Commission – In the Matter of Steven A. Cohen

- **S.A.C., hedge fund investment advisers founded and owned of by Steven A Cohen, failed to supervise two of its employees who engaged in insider trading**.
- **Cohen failed to take reasonable steps to investigate and prevent such violations**.
- The Commission therefore thought necessary that public administrative proceedings be instituted to determine: (i) whether the allegation against S.A.C. and Cohen are true, to afford the Respondent with an opportunity to establish a defense, and (ii) what if any, remedial action is appropriate.

United States v. S.A.C. Capital Advisors, LLP

- Indictment **charges the corporate entities responsible for management of a major hedge fund with criminal responsibility for insider trading**.
- Unlawful conduct by individual employees and institutional indifference to resulted in substantial and pervasive insider trading activity.
- **Defendants (through portfolio managers and research analysts) obtained inside information from dozens of publicly traded companies**. Employees traded on that information and sometimes recommended trades to S.A.C. owner
- Defendants managed to conduct these activities by:
  - Hiring portfolio managers and analysts with proven access to public company contacts likely to possess inside information
  - Providing incentives to employees to recommend to S.A.C. owner trading ideas.
  - **Failing to employ effective compliance procedures to prevent portfolio managers and analysts from engaging in insider trading.**

Dodd Frank Act

Dodd-Frank Act requires **that swap dealers and major swap participants designate a CCO who reports directly to the board of directors or to the senior officer of the registrant**. **The CCO is**

required to review and ensure the registrant's compliance with the Commodities Exchange Act (CEA), resolve conflicts of interest, and establish procedures for procedures for the remediation of noncompliance issues. The CCO must prepare and sign an annual report describing the registrant's compliance with the CEA and implementing regulations as well as company codes of ethics and conflict of interest policies. 7 U.S.C. §§ 6d(d), 6s(k).

Compliance activities are also required by self-regulatory organizations. Rule 3130 of the Financial Industry Regulatory Authority (FINRA) requires that **each member** firm must **designate a CCO** and further requires **the CEO to certify that the member "has in place processes to establish, maintain, review, test and modify written compliance policies and written supervisory procedures reasonably designed to achieve compliance"** with applicable rules, laws and regulations.
Likewise, **Rule 3012 of the National Association of Securities Dealers (NASD)** requires members to **designate an officer responsible for establishing, maintaining and enforcing a "supervisory control system.**" Among other things, this system must test and verify that the member's supervisory practices are reasonably designed to comply with applicable rules, laws and regulations.

Dodd-Frank's "**Volcker Rule" - prohibits banks and their affiliates from engaging in proprietary trading and from acquiring or retaining ownership interests in or sponsoring a hedge fund or private equity fund.** Subpart D of the final rule requires a banking entity engaged in covered activities to develop and implement a program reasonably designed to ensure and monitor compliance with the prohibitions and restrictions on covered activities and investments. A banking entity with total consolidated assets of $10 billion or less that engages in covered activities or <u>investments may satisfy the requirements by including in its existing compliance policies and procedures appropriate references to the requirements of the Dodd Frank Act.</u> For banking entities with total assets greater than $10 billion and less than $50 billion, **each compliance program must include**:

- ➢ **Written policies and procedures reasonably designed to document, describe, monitor and limit trading activities**;
- ➢ **A system of internal controls reasonably designed to monitor compliance with section 13 of the BHC Act**;
- ➢ A management framework that clearly **delineates responsibility and accountability for compliance with section 13 of the BHC Act**;
- ➢ **Independent testing and audit of the effectiveness** of the compliance program conducted periodically;
- ➢ Training for trading personnel and managers; and
- ➢ Making and keeping records sufficient to demonstrate compliance with section 13 of the BHC Act.

A banking entity with $50 billion or more total consolidated assets (or a foreign banking entity that has total U.S. assets of $50 billion or more) or that is required to report metrics under Appendix A is **required to adopt an enhanced compliance program with more detailed policies, limits, governance processes, independent testing and reporting**. Specifically, the enhanced compliance program must:

- ➢ Be reasonably **designed to identify, document, monitor and report the covered trading and covered fund activities and investments of the banking entity**;;

- **Establish and enforce appropriate limits on the covered activities and investments of the banking entity**;
- periodic independent review and testing, and ensure that the entity's internal audit, corporate compliance and internal control functions;
- Make senior management, and others as appropriate, accountable for the effective implementation of the compliance program, and ensure that the board of directors and CEO (or equivalent) of the banking entity review the effectiveness of the compliance program; and
- Facilitate supervision and examination by the Agencies of the banking entity's covered trading and covered fund activities and investments.

<u>Consumer Compliance</u>

Federally chartered banks regulated by the Comptroller of the Currency are assigned "CAMELS" ratings as part of the supervision process.
Among other things, banks are rated for "consumer compliance" -- compliance with consumer protection and civil rights statutes and regulations and the adequacy of its operating systems designed to ensure continuing compliance.
Factors to be considered include (1) **the nature and extent of present compliance** with consumer protection and civil rights statutes and regulations; (2) the **commitment of management** to compliance and their ability and willingness to assure continuing compliance; and (3) **the adequacy of operating systems**, including internal procedures, controls, and audit activities, designed to ensure compliance on a routine and consistent basis. Banks need to maintain good CAMELS ratings in order to reduce their deposit insurance premiums, receive permission to engage in business developments, and avoid unwanted regulatory scrutiny.

Banks receive consumer compliance ratings ranging from "1" (very desirable) to "5" (very undesirable). To receive the highest rating, a bank must convince the regulators that there is "**no cause for supervisory concern**." Specifically, the regulators must conclude the following:
- Management **is capable of and staff is sufficient** for effectuating compliance.
- An effective compliance program, including an efficient system of internal procedures and controls, has been established.
- Changes in consumer statutes and regulations are promptly reflected in the institution's policies, procedures, and compliance training.
- The institution provides adequate training for its employees.
- If any violations are noted, they are relatively minor deficiencies in forms or practices and are easily corrected.
- There is no evidence of discriminatory acts or practices, reimbursable violations, or practices resulting in repeat violations.
- Violations and deficiencies are promptly corrected by management.

Effectively, **the consumer compliance rating system requires banks to support a robust compliance operation**.

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D. Mitigation of penalties

A way to induce organizations to institute compliance programs or conduct internal investigations is to offer **opportunities to mitigate penalties**.

One of the earliest and still most important of the mitigation strategies is from the Environmental Protection Agency:

<u>EPA, Incentives for Self-Policing: Discovery, Disclosure, Correction and Prevention of Violation</u>

Conditions for policy application:

1. **Systematic Discovery of the Violation** Violation discovered through either (a) an environmental audit, or (b) a compliance management system that reflects due diligence in preventing, detecting and correction violations.
2. **Voluntary discovery** Identified voluntarily and not through a monitoring, sampling or auditing procedure that is required by statute, regulation, permit, judicial or administrative order or consent agreement.
3. **Prompt disclosure** Writing to EPA within 21 calendar days after discovery.
4. **Discovery and disclosure independent of Government/third party plaintiff** The entity must discover the violation independently.
5. **Correction and remediation** Entity must remedy any harm caused by the violation and expeditiously certify in writing to appropriate Federal, State and local authorities that it has corrected the violation.
6. **Prevent recurrence** Take steps necessary to prevent a recurrence of the violation after it has been disclosed.
7. **No repeat violations** Repeat offenders barred from receiving Audit Policy credit.
8. **Other violations excluded** Policy excludes violations which result in serious actual harm to the environment or which may have presented an imminent and substantial endangerment to public health or environment. Also excluded are specific terms of any order, consent agreement or plea agreement.
9. **Cooperation** The regulated entity must cooperate as required by EPA and provide the Agency with the information it needs to determine Policy applicability.

Incentives for self-policing:

The **Audit Policy identifies major incentives that EPA** provides to encourage self-policing, self-disclosure, and prompt self-correction:

- **Eliminating gravity-based penalties** When the regulated party meets the condition of systematic discovery, the gravity based-penalties which correspond to punitive portion of the penalty may be eliminated.
- **75% reduction of gravity-based penalties** Applies when <u>the disclosing entity does not detect the violation through systematic discovery but meets all other policy conditions</u>.
- **No recommendations for Criminal Prosecution** EPA generally does not focus its criminal enforcement resources on entities that voluntarily discover, promptly disclose and expeditiously correct violations unless there is potential culpable behavior that merits criminal investigation.
- **No routing requests for Audit Reports** EPA reaffirms its Policy… to refrain from routine requests for audit reports. That is, EPA has not and will not routinely request copies of audit reports to trigger enforcement investigations.

<u>SEC, Report of Investigation pursuant to section 21 (a) of the Securities Exchange Act of 1934 and Commission Statement on the Relationship of Cooperation to Agency Enforcement Decisions</u>
Exchange Act Release No. 44969 (Oct. 23, 2001)

Relevant pronouncement by the SEC, because it refrained from administering a sanction against a company in order to send a message to the industry about what should be done in case of a violation and what criteria the agency takes into account to give credit to the company that incurs in violation.

The case involved an employee of subsidiary that gave information that caused the parent company's books and accounting records to be inaccurate. The company took immediate action by disclosing the facts to the SEC and taking necessary corrective and discipline actions.

…when business seek out, self report and rectify illegal conduct, and otherwise cooperate with Commission staff, large expenditures of government and shareholder resources can be avoided and investors can benefit more promptly…

The SEC provides a list of several factors that **will take into account to give credit**, but they do not commit to any specific case… **they are careful <u>not</u> to indicate that cooperation of this sort will automatically be a shield against liability**.

E. Advice

Regulated entities have a wide range of resources they can turn for advice:
- Law firms
- Accountants
- Compliance consultants
- <u>Regulators </u> The regulators offer extensive advice, not only on a general level through web site information, public guidelines but also through specific advice. (Highly regulated industries have extensive contact with their regulators; for example large banks or pharmaceutical companies)

<u>Professors questions and comments:</u>

- Informal advice from regulators can be tainted with conflicts of interest: *Bragg v United States* Inspectors of the Federal Mine Safety and Health Administration did not perform their job correctly when the level of scrutiny of the inspector was affected by a close relationship with the regulated agency.

F. Admissions

If an enforcement proceeding goes to a liquidated judgment, the determination could be used against the defendant in a subsequent lawsuit: The facts and conclusions necessary to the judgment might give rise to an estoppel which would bar the defendant from denying them in a subsequent case.

In the case of a settlement, the effect is more ambiguous. The settlement with an agency might be seen as a purely private compromise that establishes no facts at all, however, defendants worry that the settlement may be used against them in future lawsuits by shareholders, etc.

To avoid risks in the future, **defendants generally insist that settlement agreements with the government recite that <u>they do not admit misconduct; that they do not accept nor deny</u>**. The government's willingness to agree to such stipulations is often necessary to close an agreement.

The following excerpt reflects how a New York trial court Judge did initially not authorize a settlement between Citibank and the SEC as it concludes that Citibank did not assume responsibility.

<u>SEC's memorandum of law in response to questions posed by the court regarding proposed settlement</u>
SEC v Citigroup Global Markets INC

The SEC alleged that Citigroup Global Markets had engaged in misrepresentations in connection with the marketing of collaterized debt obligation securities.

The Court however, posed a number of questions to the parties regarding the proposed settlement. The SEC responded to the following questions…

Why should the Court impose a judgment in a case in which the SEC alleges a serious securities fraud <u>but the defendant neither admits nor denies wrongdoing</u>?

The SEC replies by arguing it has been a standard practice of the SEC to utilize consent decrees in which defendants admit no wrongdoing. They also cite to a policy adopted in 1972 in which the defendants after a consent decree in which they admit no wrongdoing, must maintain in the future a no admit/deny position regarding the subject.

They also replied that consistent with this policy, Citigroup and the Commission have entered into a no admit/deny settlement.

The SEC also points out that "obviously there are advantages and disadvantages to both parties in a no admit/deny consent judgment. The defendant is not subject to collateral estoppel with regard to the claims asserted, but at the same time investors are able to pursue any available private remedies in addition to the relief obtained by the SEC. On the other hand, the Commission is able to bring the matter to a speedy resolution, obtain compensation for victims in a timely manner, and allocate its limited resources to bringing additional enforcement actions for the protection of still more investors".

<u>SEC v. Citigroup Global Markets Inc.</u>
(S.D.N.Y. Nov. 28, 2011)

Response by judge Rakoff to the above arguments of the SEC:

"The Court concludes, regretfully, that the proposed Consent judgment is neither fair, nor reasonable, nor adequate, nor in the public interest".

…. "**It is not reasonable, because how can it ever be reasonable to impose substantial relief on the basis of mere allegations?** It is not fair, because, despite Citigroup's nominal consent, the potential for abuse in imposing penalties on the basis of facts that are neither proven nor acknowledged is patent. It is not adequate, because, in the absence of any facts, the Court lacks a framework for determining adequacy. And, most obviously, the proposed Consent Judgment does not serve the public interest, because it asks the Court to employ its power and assert its authority when it does not know the facts".

"It is harder to discern from the limited information before the Court what the SEC is getting from this settlement other than a quick headline. <u>By the SEC's own account, Citigroup is a recidivist, and yet, in terms of deterrence, the $95 million civil penalty that a Consent Judgment proposes is pocket change to any entity as large as Citigroup</u>"….

Professor's update

Issue solved by Court of Appeals in favor of the SEC and settlement approved

SEC v. Citigroup Global Markets, Inc.
752 F. 3d 285 (2nd Cir. 2014)

The judges in appeal held that the district court abused its discretion by applying an incorrect legal standard in assessing the consent decree and setting a date for trial.

The Court recognizes a strong federal policy favoring the approval and enforcement of consent decrees.

A **Court evaluating** a proposed SEC consent decree for fairness and reasonableness should at a minimum **asses** (1) the **basic legality of the decree**; (2) **whether the terms of the decree, including its enforcement mechanism are clear**; (3) whether **the consent decree reflects a resolution of the actual claims in the complaint;** and (4) **whether the consent decree is tainted by improper collusion or corruption of some kind**.

The Court may not take into account an adequacy standard. Scrutinizing a proposed consent decree for "adequacy" appears borrowed from the review applied to class action settlements, and strikes us as particularly inapt in the context of a proposed SEC consent decree. The consent decree does not foreclose private parties to future claims.

It is an abuse of discretion to require, as the district court did, that the SEC establish the truth of the allegations against a settling party as a condition for approving the consent decrees. Trials are primarily about the truth. Consent decrees are primarily about pragmatism.

The job of determining whether the proposed SEC consent decree best serves the public interest rests with the SEC and its decision merits significant deference. Federal judges, who have no constituency, have a duty to respect legitimate policy choices made by those who do. <u>The responsibilities for assessing the wisdom of such policy choices and resolving the struggle between competing views of the public interest are not judicial ones. Our Constitution vests such responsibilities in the public branches.</u>

On remand, **the district court cannot determine that the public interest is disserved based on its disagreement with the SEC's decision on its discretionary matters of policy**, such as deciding to settle without requiring an admission of liability.

For the reasons given above, the November 28, 2011 order from the district court is vacated and case is remanded for further proceedings in accordance with this opinion…

Advice

An important task for attorneys representing defendants in enforcement cases is to negotiate for language that releases the client from the broadest possible scope of claims; the regulator, on the other hand, is likely to seek considerably narrower scope.

This was an issue for Wells Fargo in 2014, when it entered into a settlement agreement in 2012 for $5 billion with the US and 49 states to settle actions related to home mortgage practices. In further claims they tried to set the prior consent decree as a bar to litigation, but no avail: the D.C. Circuit held that the "sole" basis" language of the release permitted the Government to go forward on claims that Wells Fargo had engaged in other violations with respect to the same mortgages.

Oversight liabilities of certain officers within an organization

When, if at all, should compliance officers be liable for failure to supervise personnel at an organization who commit compliance violation?

The question arises because compliance officers are generally charged with ensuring that the organizations they serve comply with the law, and thus could be said to exercise a form of supervisory authority over everyone in the organization.

As a matter of discussion, the following example:

<u>In the matter of Theodore W. Urban</u>
<u>SEC Administrative Proceeding</u>

Theodore **Urban** was the **general counsel** and **member of the board of directors** of a registered securities broker dealer. **When a broker at the company engaged in fraudulent acts, Urban was accused and investigated for oversight liability**.

He was able to prove that he raised alerts to Managers above him but no one responded. He urged that the broker be fired but the executives at the retail sales department refused.

The CEO deferred to managers in the retail sales department even on matters of ethics and compliance and did not back up up Urban's recommendation that the broker be fired. This tells a lot about the "tone at the top" of this compay.

The hearing examiner defined the standard of liability as follows: ***"Even where knowledge of supervisors is limited to "red flags" or "suggestions" of irregularity, they cannot discharge their supervisory obligations simply by relying on the unverified representations of employees….Instead…. there must be adequate follow-up and review when a firm's own procedures detect irregularities or unusual trading activity***".

Applying this standard, the hearing examiner concluded that **Urban had behaved reasonably under the circumstances**, and accordingly could **not be held liable** for failing to supervise the broker.

<u>Professor's comments and questions</u>:
The full SEC failed to act in this case, thus leaving the hearing's examiner opinion undisturbed. The SEC has, however, issued guidance on the question of when compliance officials become supervisors ***"Compliance and legal personnel are not per se supervisors, but that this status depends on whether, under the facts and circumstances of a particular case, that person has the requisite degree of responsibility, ability or authority to affect the conduct of the employee whose behavior is in issue"***

Chapter 7- Prosecutors	Pages 243-270

Prosecutors

A. The problem of corporate criminal liability

Some arguments questioning the **criminal liability of corporations**:

- Companies are not human beings. How can a company have the *mens rea* required for criminal liability?
- Companies cannot be imprisoned or executed; the most effective-and essentially the only-criminal penalty against a corporation is a fine.
- The negative effects of a fine will fall on the company's shareholders, damaging not only the reputation but also the value of the stock.

<u>Samuel W. Buell, The Blaming function of Entity Criminal Liability</u>

Buell addresses the issue that if the only pain that a state can inflict in a legal entity is fiscal, there is said to be little point. But he supports the existence of criminal liability with certain arguments.

He also covers the three points of view regarding criminal corporate liability: (i) Those who consider that retribution against nonhuman legal forms is nonsensical and pointless; (ii) those who are doubtful, that criminal law could add anything useful to the project of regulating firms, which can suffer only financial consequences from legal action; and (iii) those who embrace a popular impulse to condemn entities criminally for the harms they visit upon people.

He argues that in modern life, an organization can be blamed for wrongdoing with a kind of moral assessment characteristic of judgments of criminality and on the basis of the organization's relationship to the wrong. **Because of its communicative force and preference-shaping authority, only criminal process fully produces these effects of legally imposed entity blame….**

B. The decision to prosecute

Prosecutors have the power of prosecutorial discretional, in which they have considerable freedom to charge or not to charge an offender based on the application of relatively unconstraint judgment.

This discretion is supported by limited resources of the prosecutorial offices, and also by the devastating consequences of an indictment for the person being charge. However, too much discretion can also impair the deterrence objectives of the criminal law. Prosecutors have a manual and follow certain guidelines.

<u>United States Attorney Manual, Principles of Federal Prosecution of Business Organizations (2013)</u>

Principles that guide the US Department of Justice in deciding whether or not to charge corporations with criminal offenses.

In summary the manual covers the following topics:

Duties of prosecutors: Federal prosecutors and corporate leaders typically share common goals. For example, directors and officers owe a fiduciary duty to a corporation's shareholders, the corporation's true owners, and they owe duties of honest dealing to the investing public in connection with the corporation's regulatory filings and public statements.

Considerations of corporate liability ⌧ Corporations should not be treated leniently because of their artificial nature nor should they be subject to harsher treatment.

Factors to be considered: Generally, prosecutors apply the same factors in determining whether to charge a corporation as they do with respect to individuals. However, the corporate entity requires to take into account the following:

- the nature and seriousness of the offense, including the risk of harm to the public, and applicable policies and priorities,
- the pervasiveness of wrongdoing within the corporation;
- the corporation's history of similar misconduct;
- the corporation's timely and voluntary disclosure of wrongdoing;
- the existence and effectiveness of the corporation's pre-existing compliance program;
- the corporation's remedial actions, including any efforts to implement an effective corporate compliance program or to improve an existing one, to replace responsible management;
- collateral consequences, including whether there is disproportionate harm to shareholders, pension holders, employees, and others;
- the adequacy of the prosecution of individuals responsible for the corporation's malfeasance; and
- the adequacy of remedies such as civil or regulatory enforcement actions.

Special Policy Concerns: The nature and seriousness of the crime, including the risk of harm to the public from the criminal misconduct, are obviously primary factors in determining whether to charge a corporation. Principles, prosecutors must consider the practices and policies of the appropriate Division of the Department, and must comply with those policies to the extent required by the facts presented.

<u>Professor’s comments on the manual</u> ⌧

- The manual follows the theory of *<u>respondent superior</u>*, in which any act of any corporate employee may be the basis for corporate criminal liability, so long as it is committed in the scope of employment or with an intent to serve the company.
- However, not all conduct is punishable, under the concept of *<u>pervasiveness</u>* ⌧ Charging a corporation for even minor misconduct may be appropriate where the wrongdoing was pervasive and was undertaken by a large number of employees, or by all the employees in a particular role within the corporation, or was condoned by upper management.
-

C. Plea Bargains, deferred prosecution agreements, and non-prosecution agreements (Also in the Manual)

Corporate criminal cases rarely go to trial. Much more commonly, the prosecutor's charges will be resolved by any of the following pretrial dispositions:

1.Plea bargains: Any agreement in a criminal case between the prosecutor and defendant whereby the defendant agrees to plead guilty to a particular charge in return for some concession from the prosecutor.

28.1300 Plea Agreements with Corporations:
In negotiating plea agreements with corporations, as with individuals**, prosecutors should generally seek a plea to the most serious, readily provable offense charged**. In addition, the terms of the plea agreement **should contain appropriate provisions to ensure punishment, deterrence, rehabilitation, and compliance with the plea agreement in the corporate context**. Although special circumstances may mandate a different conclusion, **prosecutors generally should not agree to accept a corporate guilty plea in exchange for non-prosecution or dismissal of charges against individual officers and employees**.

As with natural persons, pleas **should be structured so that the corporation may not later "proclaim lack of culpability or even complete innocence."** Thus, for instance, there should be placed upon the record a sufficient factual basis for the plea to prevent later corporate assertions of innocence.

Professor's comments on plea bargains

- *North Carolina v Alford*, a Supreme Court case held that a court may accept the defendant's guilty plea, notwithstanding later protestations of innocence, if the plea is knowingly and deliberately made and the record contains sufficient evidence of guilt. The Alford case allows courts in appropriate circumstances to refuse to give effect to the defendant claims of innocence when reviewing plea bargain agreements.
- Pleas of *nolo contendere* (no contest), in which defendant neither admits or denies guilt but which has the same effect as a guilty plea for purposes of plea bargaining. Although not prohibited in federal courts, the US Department of Justice generally refuses to negotiate them.

2. Deferred prosecution agreements (DPA's): T**he defendant complies with the government's investigation and agrees to implement remedial measures and in exchange the government agrees to defer the filing of charges**. If the defendant satisfies the government that it has **fully complied with its promises, the Government never brings the prosecution.**

3. Non-prosecution agreements (NPA's): Similar to the DPA except that the government is satisfied with the target's compliance and therefore agrees to drop the case at the same time of the agreement. They are more definitive and are typically seen only when the target has made a prompt self-report of the violation and provided the government with extensive cooperation in its investigation.

9-28.1000 Collateral Consequences:

Comment: where the collateral consequences of a corporate conviction for innocent third parties would be significant, **it may be appropriate to consider a non-prosecution or deferred prosecution agreement with conditions designed, among other things, to promote compliance with applicable law and to prevent recidivism.**

Professor's comments on DPA's and NPA's

- **DPA's and NPA's don't have to be presented to a court for review. There is no judicial evaluation of the credibility of the government's case or the reasonableness of its legal theories.**
- Companies **do not admit guilt under a DPA or NPA**, what stops them from subsequently proclaiming their innocence.

United States v. Aibel Group Limited

Example of a company charged with a **violation of the Foreign Corrupt Practices Act and agreed to enter into a deferred prosecution agreement (DPA) for a term of 3 years in which it commits to cooperate and institute remedial measures to ensure the conduct will not recur**.

Professor's comments on Aibel's corporation DPA

- The company is obliged to ensure the **conduct will not recur** by taking measures that will relate to some sort of corporate governance changes related to compliance.
- Other sort of provisions usually required by prosecutors in this type of agreements:
  - Commitments to **fire specified employees**
  - Creations of **specified managerial positions**, such as a Chief Compliance Officer or a Chief Risk Officer
  - Guarantee or **reporting lines** for these or other officers to the chief executive officer
  - Splitting of the positions of board chairman and CEO
  - **Addition of Directors**
  - Additional guarantees of director independence
  - Creation of new board committees or the vesting of new powers in existing committees
  - Retention of a consultant, paid by the defendant, to recommend additional governance changes.

D. Sentencing

Federal Sentencing Guidelines for Organizations

The sentencing of corporations convicted of federal crimes **is heavily influenced by the following guidelines which provide that in some circumstances a corporate defendant may receive a more lenient sentence if it has in place an "effective compliance and ethics program"**:

§8B2.1. Effective Compliance and Ethics Program

(a) To have an effective compliance and ethics program, …….. an organization shall—

(1) Exercise due diligence to prevent and detect criminal conduct; and

(2) otherwise promote an organizational culture that encourages ethical conduct and a commitment to compliance with the law.

Such compliance and ethics program shall be reasonably designed, implemented, and enforced so that the program is generally effective in preventing and detecting criminal conduct. The failure to prevent or detect the instant offense does

not necessarily mean that the program is not generally effective in preventing and detecting criminal conduct.
(b) Due diligence and the promotion of an organizational culture that encourages ethical conduct and a commitment to compliance with the law within the meaning of subsection (a) minimally require the following:

(1) The organization shall establish standards and procedures to prevent and detect criminal conduct.
(2) (A) 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.
(B) High-level personnel of the organization shall ensure that the organiza-tion has an effective compliance and ethics program, as described in this guideline. Specific individual(s) within high-level personnel shall be assigned overall responsibility for the compliance and ethics program.
(C) Specific individual(s) within the organization shall be delegated day-to-day operational responsibility for the compliance and ethics program. Individual(s) with operational responsibility shall report periodically to high-level personnel and, as appropriate, to the governing authority, or an appropriate subgroup of the governing authority, on the effectiveness of the compliance and ethics program. To carry out such operational responsibility, such individual(s) shall be given adequate resources, appropriate authority, and direct access to the governing authority or an appropriate subgroup of the governing authority.
(3) The organization shall use reasonable efforts not to include within the substantial authority personnel of the organization any individual whom the organization knew, or should have known through the exercise of due diligence, has engaged in illegal activities or other conduct inconsistent with an effective compliance and ethics program.
(4)(A) The organization shall take reasonable steps to communicate periodi¬cally and in a practical manner its standards and procedures, and other aspects of the compliance and ethics program, to the individuals referred to in subparagraph (B) by conducting effective training programs and otherwise disseminating information appropriate to such individuals' respective roles and responsibilities.
(B) The individuals referred to in subparagraph (A) are the members of the governing authority, high-level personnel, substantial authority personnel, the organization's employees, and, as appropriate, the organization's agents.
(5) The organization shall take reasonable steps—
(A) to ensure that the organization's compliance and ethics program is followed, including monitoring and auditing to detect criminal conduct;
(B) to evaluate periodically the effectiveness of the organization's compliance and ethics program; and
(C) to have and publicize 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.
(6) The organization's compliance and ethics program shall be promoted and enforced consistently throughout the organization through (A) appropriate incentives to perform in accordance with the compliance and ethics program; and (B) appropriate disciplinary measures for engaging in criminal conduct and for failing to take reasonable steps to prevent or detect criminal conduct.
(7) After criminal conduct has been detected, the organization shall take reasonable steps to respond appropriately to the criminal conduct and to prevent further similar criminal conduct, including making any necessary modifications to the organization's compliance and ethics program.
(c) In implementing subsection (b), the organization shall periodically assess the risk of criminal conduct and shall take appropriate steps to design, implement, or modify each requirement set forth in subsection (b) to reduce the risk of criminal conduct identified through this process.

Professor's comments on Sentencing

- **The guidelines are an important incentive for firms to adopt compliance programs** in order to mitigate the severity of their sentences if they were subsequently convicted of federal crimes, and also serve as a model for compliance programs outside the criminal justice sphere.

Whistleblowers

1. Definition of Whistleblowers
    a. **Whistleblower is not**:
        i. A law enforcement agent → it's part of his job to investigate and report violation
        ii. Internal or external auditor → it has a formal responsibility to check and report violations
    b. Whistleblower is:
        i. A volunteer who has personal knowledge of misconduct within an organization and who comes forward on her own
    c. **<u>The term whistleblower refers to a person who, without being required to do so, reports on misconduct within an organization</u>**

2. **What does a whistleblower do?** → Testimony of Sherron Watkins (Enron Scandal)
    a. She was hired in 1993 by Mr. Fastow (CFO of Enron)
    b. In 2001, she started working under Mr. Fastow and her tasks were to review all assets that Enron considered for sale and determining the economic impact of the sale
    c. During her review she found out that:
        i. A number of assets where hedged with Raptor → according to the hedging agreement → Enron should realize the hedged price of the Raptor
        ii. Raptor special purpose entity → owned by LJM run by Fastow
        iii. Raptor hedge declined in value such that Raptor would have a shortfall and would be unable to cover the hedge price owed to Enron
    d. She requested explanations
    e. She was not satisfied with the responses of Mr. Skilling (CEO of Enron) and Fastow (CFO)
    f. After resignation of Skilling as CEO she informed the Chairman (Mr. Lay) → through an anonymous letter
    g. She met also the GC of Enron and provided a copy of the letter + 2 memos
    h. She met in person Mr. Lay → meeting lasted for 30 mins → she provided the President with 5 memos with all the problems of the company
        i. Main document discussed → "Summary of Raptor Oddities"
            1. By that time Raptor owed to Enron $700mlns
    i. Mr Lay assured that he would look into her concerns

3. **Encouraging Whistleblowing**
    a. Sometimes whistleblowers are rewarded for their actions
        i. E.g. Cynthia Cooper → she revealed the scandal of World.com
        ii. E.g. Watkins → Enron scandal
    b. However, whistleblowing is often considered "snitching" and seen in a bad way by organizations in which a "rule of silence" tends to prevail and be the dominant rule.
    c. Life of whistleblowers is not easy → many of them lost their jobs, and never worked in the same industry again
    d. Many explanation for the "rule of silence":

        i. Intimidation
        ii. Peer pressure
        iii. Identification factor nearly everyone has done something wrong
    e. How it is possible to counteract the “anti-snitching” norms?
    f. Tone at the top
        i. Many employees are deterred from coming forward by 2 concerns:
            1. Their complaints will not be heard
            2. They will suffer retaliation
        ii. Senior managers need to reassure whistleblowers that their complaints would be heard and the organization wouldn’t retaliate against them
    g. Protection for Whistleblowers
        i. Numerous state and federal statutes protect whistleblowers from retaliation by employers for actions informing the authorities of potential misconduct:
            1. **Sarbanes-Oxley Act §1514A** prohibits publicly traded companies from retaliating against people who provide information in connection with an investigation for breach of the securities law
        ii. Whistleblowers protection is also provided by many organizational code of ethics:
            1. Organization usually commits not to retaliate against people who in good faith bring potential misconduct to the attention of senior managers
    h. Rewards
        i. Organization may reward the whistleblowers financially e.g. bonuses, or promotion
        ii. Governments have been less cautious about offering rewards
            1. Criminal law enforcement has traditionally used a whistleblower device in the form of rewards offered for information leading to the arrest or conviction of wrongdoer
            2. SEC’s whistleblowers bounty program Regulation 21F
                a. Authorizes payments to individuals who voluntarily provide the SEC with original information that leads to an SEC enforcement action generating more than $1mln in sanction can receive from 10% to 30% of the sanction
                    i. Examples:
                        1. UBS former UBS banker Birkenfeld received a $140mln reward for revealing illegal actions by UBS and Swiss Banks in facilitating tax frauds by US citizens
            3. Federal Financial Institution Reform, Recovery and Enforcement ACT
                a. Makes illegal to execute or attempt to execute a scheme to defraud a financial institution or to make false entities on the books of a financial institution
                b. Private individuals may submit confidential claims of breaches of the FIRREA to the Department of Justice
                    i. If the department initiates an action the whistleblower gets between 20% - 30% of the first

million, 10%-20% of the next 4 million, and 5%-10% of the next 5 million cap of $ 1.6mln

- **i. Mandatory Reporting**
    - **i.** Organizations may require people with knowledge of breaches to report, with penalty of being sanctioned in case of silence.
        - **1.** Apple policy if there is a knowledge of violations of any Apple's policy such violation must be notified to either your manager (unless he is involved in the breach), HR, Legal, Internal Audit, Finance or Business conduct help line Failure may result in disciplinary sanctions
    - **ii.** BAR Association's Model Rule 8.3 a lawyer who knows that another lawyers has committed a violation of the Rules of Professional Conduct that raises a substantial question as to that lawyer's honesty, shall inform the relevant professional authority

4. Whistleblowers Policy

- **a.** Example from OVB Inc.
    - **i.** Scope
        - **1.** Provide process for the anonymous submission of suspected wrong doing by any employee of OVB or any person who may have concerns about illegal or unethical behavior
        - **2.** Concerning:
            - **a.** Fraud or deliberate errors in the preparation, evaluation, review or audit of any financial statements of OVB
            - **b.** Fraud or deliberate errors in recordkeeping
            - **c.** Deficiencies in OVB's accounting controls
            - **d.** Misrepresentations or false statements in the financial records
            - **e.** Any deviation in the fair representation of the OVB's financial conditions
    - **ii.** Reporting illegalities
        - **1.** Complaints must be accurate
        - **2.** Complaints to be reported to the Chief Compliance Officer or the CEO
        - **3.** Confidentiality will be kept to the extent possible
    - **iii.** Complaints
        - 1. It must be factual rather than speculative
        - 2. Contains specific info
            - a. Alleged event, matter or issue
            - b. Name(s) of people involved
            - c. Approximate time or location of specific events
            - d. Additional info and documentation or other supporting evidences
    - iv. Investigation of Claims
        - 1. Copy of complaints to be forwarded to the Audit Committee and reviewed at the next regularly scheduled meeting
        - 2. Investigation conducted under the supervision of either Audit Committee or the CEO

        3. The compliance officer will conduct the investigation → the Audit Committee reserves the right to designate another individual to perform an investigation if necessary
        4. The Audit Committee shall review the results and determine the corrective action, or direct further investigation, if necessary
    v. Investigation Reports
        1. Findings of investigations → indication of findings of fact, conclusions and recommendations
        2. Copy of the report to be provided to the Compliance Officer
    vi. Deposition of Claims
    vii. Confidentiality
        1. OVB shall maintain the confidentiality or anonymity of the individual(s) making the complaint to the fullest extent reasonably practicable
        2. Identity of people involving in the investigation → kept confidential
    viii. Prohibition of Retaliation
    ix. Abuse of Practices and Procedures and Meritless Claims
        1. It's a violation → report information that are known to be false, misleading or unfounded
        2. Employees → not to be afraid to report information because they are uncertain or unable to determine the merits of their complaint

5. **Responding to the Whistleblower**
    a. Sometimes revelations of Whistleblower are explosive
    b. Premature disclosure may be dangerous
    c. First Step
        i. Internal Investigation
            1. E.G. internal investigation Enron:
                a. GC and Chairman of Enron agreed that they should hire a law firm to conduct investigation → hired Vinson & Elkins (VE)
                b. Investigation should have been a preliminary one → designed to determine whether there were facts indicating that full investigation should be determined
                c. VE obtained docs from GC
                d. VE conducted interviews
                e. VE had informal discussions with lawyers in the firm who worked on some LJM transaction
                f. VE interviewed Watkins
                g. VE met GC and Chairman of Enron → reporting findings
                h. Investigation covered 4 areas related to interview of Watkins:
                    i. Apparent conflict of interest due to Fastow's role in LJM
                    ii. Accounting treatment of Raptor's transaction
                    iii. Adequacy of the public disclosure of the transactions
                    iv. Impact on Enron's financial statements
                        1. Findings:
                            a. Transactions were compliant

        b. Transactions were duly approved by legal, technical and commercial professionals
        c. On the conflict, VE concluded that none of the individuals interviewed could identify any transaction between Enron and LJM that was not reasonable from Enron's standpoint or that was contrary to Enron's best interest
        d. Accounting → Enron and Andersen say that treatment was aggressive, but ok
    i. The results of the investigation of VE were largely predetermined by the scope and nature of the investigation and the process employed
    j.

6. **Protection of Whistleblowers → Sarbanes-Oxley Act §1514**
   Lawson v. FMR LLC
    a. Sarbanes-Oxley act aims at preventing and punish corporate and criminal fraud, protect victims, preserve evidences of such fraud, and hold wrongdoers accountable for their actions
    b. **Enron succeeded in perpetuating its massive shareholder fraud due to the "corporate code of silence" → and fear of retaliation**
    c. Congress identified the lack of whistleblower protection as significant deficiency in the law, for in complex securities investigations
    d. §1514A Sarbanes-Oxley Act
        i. **(a) Whistleblower Protection for Employees of Publicly Traded Companies** No [public] company with or any officer, employee, contractor, subcontractor, or agent of such company or nationally recognized statistical rating organization, may discharge, demote, suspend, threaten, harass, or in any other manner discriminate against an employee in the terms and conditions of employment because of any lawful act done **by the employee**
            1. **(1)** to provide information, cause information to be provided, or otherwise assist in an investigation regarding any conduct which the employee reasonably believes constitutes a violation of section 1341, 1343, 1344, or 1348, any rule or regulation of the Securities and Exchange Commission, or any provision of Federal law relating to fraud against shareholders, when the information or assistance is provided to or the investigation is conducted by a federal agency
    e. Congress assigned protection to whistleblowers to the Department of Labor → it's determination are the agency's final decision and is reviewable in federal court under the standards stated in the Administrative Procedure Act
    f. An employee prevailing in a §1514A claim is entitled to "all relief necessary to make the employee whole" → including reinstatement in the same job position
    g. Plaintiffs
        i. Initiated claim against their employers → privately held corporations that provide advisory and management services to mutual funds

h. FMR moved to dismiss → FMR is privately held while §1514A protects only employees of public companies

i. Certiorari granted to address the issue as to whether §1514A extends whistleblowers protection to employees of privately held contractors who perform work for public companies:

j. FMR interpretation is that a correct interpretation requires to add "of a public company" after the word "employee"

k. In reality, nothing in §1514's language confines the class of employees to those of a designated employer

- **i.** Interpretation of FMR is too narrow
- **ii.** Court found reason to believe that Congress presumed an employer-employee relationship between the retaliator and the whistleblower
- **iii.** The senate report → showed that Congress was focused on the role of Enron's outside contractors in facilitating the fraud
- **iv.** Outside professionals bear significant responsibility for reporting fraud by the public companies with whom they contract → fear of retaliation was the primary deterrent to such reporting by the employees of Enron's contractors
- **v.** Affording whistleblowers protection to mutual fund investment advisers is crucial to the Sarbanes-Oxley Act's endeavor to protect investors → protection shall be extended to employee of the advisors, contractors and subcontractors
- **vi. Dissenting opinion**
    - **1.** The court extended too much the provision
    - **2.** Potentially also a baby sitter may bring a federal case against her employer if the parent stops employing the babysitter after she expresses concern that the parent's teenage son may have participated in an internet purchase fraud

7. Dodd-Frank Act §78u-6(h)(1)(A) → contains similar provision to §1514A

a. Whistleblower is any individual who provides information relating to a violation of the securities laws to the commission

- **i. If the info → don't reach the SEC → no protection**

8. QUI TAM ACTIONS

a. Qui Tam litigation → are vey used to encourage whistleblowers to come forward by offering them bounties

- **i.** §3730 of False Claim Act →
    - **1.** a private party can file a lawsuit on behalf of the government charging that a person has made a false claim on the government in breach of §3729
        - **a.** The relator must deliver copy of the complain to the government
        - **b.** In 60 days the government can decide whether to intervene
        - **c.** If the government doesn't intervene, the relator may continue on her own
            - **i.** Relator's bonuses

            1. From 15% to 25% if the Government intervenes
            2. From 25% to 30% if it does not
        2. Responsible to the litigation is the first person to file
        3. Litigation cannot be brought on the basis of public information, unless the relator is an original source of the information
            a. Individual who:
                i. Prior to the litigation has already disclosed the info to the government
                ii. Has knowledge that it is independent of and materially adds to the publicity disclosed allegations
    b. Power of such actions → Relator can continue the action even if the government doesn't act

9. Darity v. CR Bard

a. Plaintiff Darity → qui tam action to recover treble damages and civil penalties on behalf of the USA → claim:
    i. Defendants have submitted and/or caused to be submitted false and fraudulent claims to the USA Government for payment through the use of false records and false statements
b. Plaintiff was employed by defendant CR Bard → employment terminated on November 18, 2005
c. Since 2000 → Defendant Bard has engaged in a variety of schemes designed to induce customers to purchase its brachytherapy seeds → resulted in an increased price to be subsequently paid by the Medicare and Medicaid programs
d. Bard's inducement for the customers' purchases included provision of disposable products at no cost, provision of equipment on loan for extended period at no cost, donation of capital equipment, and various inducements
e. Bard was allegedly able to engage in its illegal marketing strategy because under applicable regulations, payments for brachytherapy seeds were passed directly on to the Medicare or Medicaid programs → hospitals wouldn't lose money → customers are therefore easy to convince
f. CR Bard agreed to pay to the US $48.26mln to resolve claims that it knowingly caused claims to be submitted to Medicare program

GATEKEEPERS

A. INTRODUCTION

DEFINITION ⇒ Someone whose certification/support is needed before an organization can reach a goal

- The gate ⇒ separates the organization from an objective
- Gatekeeper ("GK") ⇒ Controls the gate ⇒ GK can prevent/impede the firm from achieving the objective if in doing so the fir would violate an applicable rule/standard.
- Whose interest does the GK takes into account when deciding whether to "open" the door or not? 2 models of the GK's role that are always in TENSION ⇒
  - *First ⇒ Zealous Advocate*
    - GK acts on behalf of the organization
    - Only concern is to serve the best interest of the client
  - *Second ⇒ Public Servant*
    - **GK serves the organization but ALSO acts in the public interest**
    - GK has a broader responsibility (ensure client complies with norms).
    - This role has become popular over the last years ⇒ Savings and loan fiasco of the 1980s.

❖ ***Lincoln Savings & Loan Case***
- Firm was insolvent – Bank regulators took control of it
- Controlling parties sued to get back control of the firm
- **RULING**⇒ To uphold the government's action
- **REASONING ⇒**
  - Financial strategies were fraudulent
  - Judge asked: where were the professionals when these actions were being consummated? Why didn't any of them speak up or disassociated themselves? Where were the outside accountants and attorneys?
  - **Private sector has to cooperate with the public oversight of regulators.**
  - **Private sector has a cynical attitude of disrespect for the law.**
  - Private sector failed to do the right thing when confronted with misconduct.

B. ATTORNEYS
- **Classic GK**
- 2 **different roles (Zealous Advocate or Public Servant)**
- **3 advantages that attorneys bring to the GK role ⇒ (i) Attorney-client privilege; (ii) Work-product doctrine and (iii) Defense of reliance on counsel.**
- These advantages ⇒ show that is good idea to involve an attorney in compliance matters / investigations

1. ZEALOUS ADVOCATES OR PUBLIC SERVANTS?
   a. Constant tension between the two roles.
   b. ABA Model Rules ⇒ Favor (in general) the role of the attorney as a zealous advocate of the client. But they recognize that attorneys are also public servants.
   c. Examples in the rules ⇒
      i. Lawyer cant lie to regulator about a material fact (4.1.(a)).

ii. Lawyer may not knowingly fail to disclose material information to a government official if the information is not otherwise protected from disclosure by confidentiality (4.1.(b))
iii. Lawyers may not (generally) impede investigation by government agencies.

d. But lawyer cannot be a "YES MAN"
e. Attorney has to find balance between these two responsibilities.

❖ ***Harris Weinstein-Attorney Liability in the Savings & Loan Crisis***

- OTS (regulator of loan institutions at the time) Administrative proceeding against Kaye, Scholer, Fierman, Hays & Handler (corporate law firm).
- 19 months later after the Lincoln ruling.
- Background ⇒
  - o 1986: Kaye was retained during a bank investigation of Lincoln
  - o Kaye wrote a letter to regulators stating that they could NOT ask Lincoln for any information and that if thy wanted information they should write a letter to the partner in NY.
- OTS allegations ⇒
  - o BY interposing itself between Lincoln and regulators ⇒ Kaye assumed the responsibility for fair and honest reporting (that otherwise would have been the bank's burden alone).
  - o Kaye made factual representations to the Bank that contained material omissions or misstatement of facts
  - o Didn't reveal that in an interview with a partner from Arthur Andersen it was reveal that AA was concerned about Lincoln's viability.
  - o **Transmission of information from Kaye to OTS was overall misleading.**
  - o **Rendered an opinion based on document that were backdated (knowing this)**
  - o **Kaye violated its fiduciary duties as a lawyer**
  - o **Kaye had an obligation to bring the unlawful conduct to the attention of the BOD**
- OTS demanded $275 million in penalties and froze the firm's assets

Questions and Comments about the case:

- For the firm ⇒
  - o Reputational loss was huge
  - o Bad publicity
  - o Kaye held out for 6 days ⇒ then ⇒ agreed to pay a $41 million fine
- For many ⇒ it symbolized a sea-change in the respective power of the government and private attorneys in compliance matters.
- Lincoln ⇒ was an example of all that could and have gone wrong ⇒
  - o Irresponsible managers
  - o Inappropriate investments
  - o Deceptive financial reporting
  - o Accounting gimmicks
  - o Aggressive use of political influence

❖ ***Laura Stevens ("LS") (GlaxoSmithKline-"GSK") Case***

- o **Facts** ⇒
  - ▪ LS was Associate General Counsel for GSK.

- **FDA launched an investigation into whether GSK had illegally promoted its depression medication for weight loss (unapproved use).**
- FDA asked GSK to turn over copies of materials presented at GSK programs related to the drug.
- LS led GSK's response to the FDA's inquiry in consultation with King & Spaulding ("King"-outside counsel – law firm).
- **LS received 40 slide decks of information – after consulting with King she turn over to the FDA 3.**
- LS prepared a spreadsheet about GSK speakers program. **After consulting with King, she deleted a column of information about the entertaining provided at the events (the FDA did not requested this information).**
- LS informed that GSK had national and local advisory board. She failed to inform that GSK also had special issue advisory boards.
- After consulting with King, **LS informed that speakers were not paid. She failed to inform that speakers did participated in entertainment activities and receive "gifts"**

o **Indictment ⇒**
- **Obstruction of official proceeding**
- **Knowingly alters, destroy, conceals (among others)…with the intent to impede obstruct, r influence the investigation or proper ad**ministration of any matter within the jurisdiction…of the USA.

o **Court ⇒**
- Access to those documents should not have been granted in the first place.
- LS was not a lawyer assisting a client in perpetrating a crime or fraud.
- **The documents show a studied and thoughtful analysis of an extremely broad request by the FDA**.
- **Response may not have been perfect or satisfied the FDA ⇒ but it was a bona fide representation and in goof faith reliance external counsel.**
- Statements made by LS cannot be taken as being false in this context.
- At the end ⇒ **The case was NOT be submitted to the jury. LS was acquitted**.

o ***Questions and comments about the case ⇒***
- It appears that LS did not provided the Government with all the information in her power. Is this obstruction of justice or zealous representation of her client?
- Judgment of acquittal was construe as a vindication of the rights of attorneys to provide a vigorous defense to clients.
- This case reflects both views of the attorney as GK ⇒
  - FDA ⇒ Sees the attorney as a Public Servant.
  - Defense ⇒ Sees the attorney as a Zealous Advocate.

2. <u>ORGANIZATION CLIENTS</u>
   a. *<u>Who is the client?</u>*
      i. Client = the organization. Not the CEO or other officer/employee
      ii. ABA Rule 1.13.

> *"(a) A **lawyer employed or retained by an organization represents the organization acting through its duly authorized constituents.***
> *(b) If a lawyer for an organization knows that an officer, employee or other person associated with the organization is engaged in action, intends to act or refuses to act in a matter related to the representation that is a violation of a legal obligation to the organization, or a violation of law that reasonably might be imputed to the organization, and that is likely to result*

in substantial injury to the organization, then the lawyer shall proceed as is reasonably necessary in the best interest of the organization. Unless the lawyer reasonably believes that it is not necessary in the best interest of the organization to do so, the lawyer shall refer the matter to higher authority in the organization, including, if warranted by the circumstances to the highest authority that can act on behalf of the organization as determined by applicable law (…)".

iii. **"Up-the-ladder reporting"** ⇒ In some circumstances the attorney has not only the permission but the **duty to refer the matter** to the higher authority (generally up to the BOD).

iv. **Note that attorney has discretion** ⇒ If he believes that is not in the best interest of the organization ⇒ the attorney does not have to act.

b. <u>Relations with employees</u>

i. **Issue ⇒ Does the attorney for the company also represents employees/individuals involved in the misconduct?**

ii. **Importance** ⇒ Application of the duty of confidentiality and attorney-client privilege:

- **If the individual is represented by the attorney ⇒ his information may be protected by confidentialit**y and therefore not subject to disclosure w/o his consent
- **For an to establish that counsel for a corporation also represented him he must ⇒**
  1) Prove that **he approached counsel for the purpose of seeking legal advice**;
  2) **Prove that in this approach he made it clear for counsel that he was seeking legal advice in his individual rather than representative capacity**;
  3) Demonstrate that **counsel saw fit to communicate with them in their individual capacities**;
  4) **Prove that conversations were confidential**;
  5) Show **that substance of conversations didn't concern matters within the company or general affairs of the company**.

iii. **If client has retained his own lawyer ⇒ Attorney can only communicate with him with this lawyer's permission (ABA Rule 4.2.)**

iv. Sometimes company agrees to pay the employee's legal fees or sign with him a joint defense agreement.

3. <u>CONFIDENTIALITY</u>

a. <u>Scope of the Lawyer's Duty of Confidentiality</u>

i. Professional obligation to maintain confidences of clients.

ii. **ABA Rule 1.6.:** *"…A lawyer shall not reveal information relating to the representation of a client (…)".*

- GR ⇒ Non-disclosure
- It covers ⇒ **ANY information related to the representation ⇒ not limited to communications (like the privilege).**

iii. **Exceptions to the general rule of confidentiality ⇒**

- <u>If client gives informed consent;</u>

a. Note: This consent needs to be informed (define term by the ABA Rules).

- <u>If disclosure is impliedly authorized to carry out representation</u>
  b. Example: Talking about the case with another partner in the firm.
  c. Canceled if client specifically prohibits the attorney to reveal the information.
- <u>Disclosures permitted under Rule 1.6. (b)</u>

(b) A lawyer ***<u>may</u>*** *reveal information relating to the representation of a client to the extent the lawyer reasonably believes necessary:*
(1) to prevent reasonably certain death or substantial bodily harm;
(2) to prevent the client from committing a crime or fraud that is reasonably certain to result in substantial injury to the financial interests or property of another and in furtherance of which the client has used or is using the lawyer's services;
(3) to prevent, mitigate or rectify substantial injury to the financial interests or property of another that is reasonably certain to result or has resulted from the client's commission of a crime or fraud in furtherance of which the client has used the lawyer's services;
(4) to secure legal advice about the lawyer's compliance with these Rules;
(5) to establish a claim or defense on behalf of the lawyer in a controversy between the lawyer and the client, to establish a defense to a criminal charge or civil claim against the lawyer based upon conduct in which the client was involved, or to respond to allegations in any proceeding concerning the lawyer's representation of the client;
(6) to comply with other law or a court order; or
(7) to detect and resolve conflicts of interest arising from the lawyer's change of employment or from changes in the composition or ownership of a firm, but only if the revealed information would not compromise the attorney-client privilege or otherwise prejudice the client.

b. <u>Special confidentiality Rules for Organization Clients</u>

i. Rule 1.6. applies for corporations
ii. But there is an additional exception to confidentiality in this context ⇒ **Rule 1.13 (c) and (d) ⇒**

"(a) A lawyer employed or retained by an organization represents the organization acting through its duly authorized constituents (…)
(c) Except as provided in paragraph (d), if
(1) despite the lawyer's efforts in accordance with paragraph (b) the highest authority that can act on behalf of the organization insists upon or fails to address in a timely and appropriate manner an action, or a refusal to act, that is clearly a violation of law, and
(2) the lawyer reasonably believes that the violation is reasonably certain to result in substantial injury to the organization,
then the lawyer may reveal information relating to the representation whether or not Rule 1.6 permits such disclosure, but only if and to the extent the lawyer reasonably believes necessary to prevent substantial injury to the organization.
(d) Paragraph (c) shall not apply with respect to information relating to a lawyer's representation of an organization to investigate an alleged violation of

law, or to defend the organization or an officer, employee or other constituent associated with the organization against a claim arising out of an alleged violation of law.

iii. ⇒ Allow lawyers to disclose information otherwise under circumstances not permitted by Rule 1.6.

iv. But ⇒ this exception is subject to stricter conditions ⇒ Lawyer must ⇒

- **(i) Reasonably believe that violation is (ii) reasonably certain to (iii) result in substantial injury to the company.**
- In such case ⇒ lawyer may reveal information ⇒ only and to the extent ⇒ that lawyer reasonably believes necessary to prevent injury

4. ATTORNEY-CLIENT PRIVILEGE

a. Scope

Upjohn v. united States ⇒

i. Facts: Management had reason to believe that subsidiaries may have made illegal payments to foreign government officials-Attorneys sent a questionnaire to employees worldwide seeking detailed information concerning the payments-The IRS subpoenaed the answers to the questionnaire and the records of the interviews-Upjohn resisted, citing attorney-client privilege

ii. Law: **Attorney-client privilege between a corporation and its counsel extends to communications between counsel and noncontrol-level employees**

iii. Reasoning:

- Purpose of Attorney-client privilege ⇒ sound legal advice depends upon the lawyer being fully informed of relevant facts + to encourage full and frank communications between attorneys and clients.
- If communications between a client and his counsel were discoverable, such communication would be largely circumscribed.
- In the context of a corporation, the information necessary for the corporation's attorney to properly represent the corporation will not always come from the corporation's "control group" (i.e. management). Often, the information will be in the possession of midlevel or even low-level employees ⇒ Communications between such employees and counsel may be no less necessary for proper representation, and therefore are no less deserving of confidentiality **⇒ Privilege must be extended to all communications between counsel and corporate employees, no matter what level.**
- **The "Control Group" test (adopted by lower court) ⇒ Rejected by Court. Too narrow.**
  - o Control Group: Officer, managers, directors, etc ⇒ responsible for directing the company's actions in response to legal advice.
  - o This Test ⇒ Restricts availability of the privilege to hose officers who play a substantial role in deciding and directing the company.
  - o This Test ⇒ It frustrates the purpose of the privilege by discouraging the communication of relevant information by employees of the client to attorneys seeking the render legal advice to the client corporation. The attorney's advice will often be more significant to noncontrol group members than to those

who officially sanction the advice, and the control group test makes it more difficult to convey full and frank legal advice to the employees who will put into effect the client corporation's policy.

iv. Analysis:

- Privilege protects communications only, not information not facts.
- Privilege does NOT protect the underlying facts
- While the attorney may not be compelled to disclose what an employee communicated him ⇒ Privilege does not bar the party seeking discovery from obtaining the information from the employee through a recognized discovery procedure (i.e. deposition).

v. Questions & Comments:

- Upjohn is a compliance case ⇒ company received information relating to bribes to foreign governments ⇒ it commenced an internal investigation ⇒ results were voluntarily shared with the SEC afterwards.
- Later cases have recognized these elements of the privilege ⇒
  - o Privilege protects communications only-not facts.
  - o Communications must have been made for the purpose of obtaining legal advice.
  - o Employee who makes the communications must have been encouraged or requested to do so by a more senior officer

b. <u>The Crime-Fraud Exception</u>

i. Even if information is protected by privilege ⇒ its production may be compelled if ⇒ communications between attorney and client are in FURTHERANCE of a crime/fraud.

ii. This exception is for future offenses.

iii. Past offenses ⇒ harm is done. This exception doesn't apply.

5. <u>WORK-PRODUCT PRIVILEGE</u>

c. <u>Hickman v. Taylor</u> ⇒

i. **Facts**: A tug sank while engaged in helping to tow a car float. 5 members of the crew drowned. Owners of tug retained a law firm to defend them against claims of the crew's families – **Lawyer did interviews and took statements in anticipation of the litigation. He prepared memoranda on these matters.** Then, **owners were sued and petitioner demanded the summary of some statements**. Lawyer declined alleging that this **information was privileged and were prepared in preparation for litigation.**

ii. Analysis ⇒

- **Notes, memoranda, mental impressions, conclusions of Lawyer ⇒ fall outside the privilege ⇒ NOT protected from discovery on that basis**.
- None of the federal rules dealing with discovery ⇒ contemplates production under these circumstances.
- **These are the "<u>work product of the lawyer</u>" ⇒ strategy, plans for litigation, mental impressions, beliefs, etc ⇒ protected form discovery**
  a. Except if petitioner can show that discovery is justified (i.e. witness is no longer available or he doesn't have other way to know the facts)

iii. Questions & Comments:

- Like Upjohn ⇒ this case concerns an internal investigation led by a lawyer.
- Note that these doctrine covers matters done in anticipation of litigation ⇒ ordinary compliance work is not done in anticipation for litigation ⇒ probably not protected by this doctrine. It would apply if there is some expectation of an adversarial proceeding.
- Work product privilege for federal litigation ⇒ Codified in Federal Rule of Civil Procedure

6. WAIVER OF PRIVILEGE
   - **a. Clients ⇒ can waive the protection of the privilege (not the lawyer).**
   - b. May be advisable to obtain credit in an investigation – be viewed as "cooperative".
   - *c. United States Attorney Manual-Principles of Federal Prosecution*
     - i. Waiving the privilege or the work product of the lawyer ⇒ is not a requisite for a corporation to be viewed as cooperative.
     - **ii. Decision to waive ⇒ should be free. Prosecutors should not ask for such a waiver.**
7. RELIANCE ON COUNSEL AS A DEFENSE TO LIABILITY
   - a. **Attorneys can also provide a potential shield against liability ⇒ "Advice of counsel theory**".
   - b. ⇒ Applies to allegations of misconduct that require the government to establish that defendant acted with some sort of culpable mental state ⇒ **Defendant can argue she sought advice from counsel and counsel assured that her actions were legally permissible ⇒ This negates the "culpable mental state"** as an element of the offense.
   - c. Is not technically an affirmative defense. Rather is a refutation of an element on the governments case-in-chief.
   - **d. But if you use this defense ⇒ Prosecutors can request the disclosure of ALL communications and information (even privileged)**

C. ACCOUNTANTS

- **a.** Job ⇒ **preparing financial statements, tax returns, reports, etc**.
- **b.** Provide services in internal financial management.
- **c.** Have to serve with independence and objectivity – they owe duties tot heir client but also have to protect public interest.
- **d.** Public relies on independence and objectivity of accountants to maintain the orderly functioning of commerce ⇒ this reliance ⇒ imposes a public interest responsibility on certified public accountants.

D. AUDITORS

1. INTRODUCTION
   - **Job ⇒ To check up on firm's financial reporting and certify investors and other that books are correct and accurate. They conduct an independent review.**
   - Public responsibility ⇒ stay independent – complete fidelity to public trust
   - ***Arthur Andersen Indictment ⇒***

     FACTS
     - AA ⇒ auditor for Enron for 16 years
       - Internal and external auditing work

- 2001 ⇒ Different events led to AA foreseeing imminent civil litigation against Enron and AA
- October 2001 ⇒ Enron announced 2 things ⇒
  - A $618 million lost
  - A reduction in shareholder equity ⇒ stock price dropped
    - This was necessary because AA and Enron had previously improperly categorized millions as an increase rather than a decrease to Enron's shareholder equity.
- AA's team ⇒ was notified of employee's allegations (Watkins) regarding possible fraud and other improprieties at Enron ⇒ use of "special purpose entities" ⇒ that enabled Enron to disguise the true financial condition of the company.
- AA audit strategy contravened the accounting methodology approved by AA's own specialist. AA continued to advise Enron against the expert advice they received.
- October 2001 - SEC ⇒ opened an inquiry into Enron
  - AA held an emergency conference with Enron
  - After that they began with the massive destruction of documents ⇒ delete computer files and shred physical records.
- November 2001- SEC ⇒ served AA with a subpoena
  - AA alerted that there could be "no more destruction of documents"

CHARGE: Obstruction of justice

- **AA knowingly, intentionally and corruptly persuaded other persons to: withhold records, alter, destroy, mutilated and conceal objects with the intent to impair the object's integrity and availability for use in official proceedings.**

- ***Questions and Comments*** ⇒
  - After this indictment ⇒ Jury convicted AA ⇒ Ceased business.
  - Years layer ⇒ Supreme Court reverted conviction ⇒ too late for AA
  - Relationship between AA (external auditor) and the company (Enron) became too "close" over the years ⇒ AA was not completely independent.
    - 16 years (lack of rotation);
    - Millions in fees;
    - AA had offices in Enron's headquarters
  - **Sarbanes-Oxley Act** ⇒
    - **Prohibited an accounting firm form acting as the external auditor of a company during the same period that the firm provides internal audit outsourcing and other services**.
    - Even for permitted services ⇒ BOD's Audit Committee ⇒ has to approve if auditing firm is retained to perform services other than external audit.

2. <u>INDEPENDENCE REQUIREMENTS</u>

- **Sarbanes-Oxley Act ⇒ Other requirements**
  - **Audit Committee** ⇒
    - <u>Responsible for selection, compensation and oversight of external auditor</u>.

        - Must pre-approved all auditing services as well as non-auditing services provided by independent auditor.
    - **Audit firms can't provide some services to their audit clients** (during the course of their audit engagement) (i.e. bookkeeping, appraisal or valuation services, fairness opinions, etc).
    - **Lead audit partners must rotate off the engagement every 5 years.**
        - Just rotation of partners-not of the firm
    - **Auditor must report certain specific information to the Audit Committee** (i.e. all accounting policies and practices to be used, all alternative treatment of financial information, etc)

3. ATTESTATION OF INTERNAL CONTROLS
    - **Sarbanes-Oxley Act** ⇒ Requires the auditor to attest to and report on management's assessment of its internal controls over financial reporting ⇒ **Auditor is responsible for assessing whether there are deficiencies in internal control over financial reporting.**
        - Deficiency = when the design or operation of a control does not allow management or employees to prevent or detect misstatements on a timely basis.
        - Material weakness in the system of controls = a deficiency in internal control over financial reporting such that there is a reasonable possibility that a material misstatement of the company's annual or interim financial statements will not be prevented or detected on a timely basis.
    - **Audit process ⇒**
        - **Auditor required to examine and evaluate all the company's internal controls over financial reporting.**
        - "***Top down approach***" ⇒ **Begin with the financial statement (understand overall risk to internal control over financial reporting) ⇒ Then focuses on entry level controls and works down to significant accounts** and disclosures.
        - Beyond obtaining information ⇒ auditor has to perform a systematic, on –site evaluation of all management's controls over financial reporting including ⇒
            - Assessment of the overall control environment:
            - Company's risk assessment processes;
            - Various control activities in place;
            - Management's information and communication processes;
            - Management own monitoring of control.

4. PCAOB ENFORCEMENT ACTIONS
    - **PCAOB ⇒**
        - **Authority to examine public accosting firms;**
        - **Authority to impose supervisory sanctions if violations of laws or regulations are discovered.**
        - Conducts annual inspections of auditor performance. The report includes evaluation of the audit firm's policies and procedures for quality control in different areas (i.e. tone at the top, practices for partner management, processes for monitoring audit performance, etc).
    - **Example ⇒ Procedure against Ernst & Young LLP**
        - Medici's independent auditor since 1990.
        - Medici sold medications that were time dated

- When customers returned expired products ⇒ Medicis provided full credit for customers for original purchase price or a new product.
- Medicis represented that it recognized product revenue at the time of sale ⇒ but because its customers also had the right to return the product ⇒ It also recorded estimates of futures product returns at the time of sale. The company used these estimated to establish a sales returns reserve that reduced revenue reported in its financial statements.
- **PCAOB ruled that E&Y failed to ⇒**
  - **Comply with PCAOB auditing standard** in evaluating this practice;
  - **Didn't exercise its duties with professional skepticism** as the company's auditor;
  - **Failed to identity and address a material departure from GAAP**.
  - Other failures.
- Sanctions ⇒ PCAOB ⇒ Censures E&Y; Censures and bars some partners form being associated with a registered public accounting firm; imposes civil penalties-

- ***Questions & Comments*** ⇒
  - **This account method ⇒ was in violation of GAAP ⇒** incorrect accounting treatment for more than 3 years ⇒ company's profits for those years was materially overstated
- **Example ⇒ Evaluation of PricewaterhouseCoopers ⇒ Among some of the critics are the following ⇒**
  - Failing to obtain sufficient support for estimates of an asset's fair value;
  - Relying too heavily on an audited client's internal controls.
  - Fail to exercise sufficient skepticism over management's estimates of key audit numbers.
  - Others.

5. COMPLIANCE AUDITS
   - **External Audit ⇒ goes beyond the specific topic of financial reporting ⇒ it includes more general compliance-based audits.**
   - **Compliance Auditor** ⇒ Examines a firm's operations to asses different things ⇒
     - Legal requirements;
     - Codes of best practices;
     - Internal ethic codes;
     - Global supply chain (labor rules, environmental rules, human rights, etc)
     - More.

E. CONSULTANTS AND MONITORS

- **Lincoln Savings** ⇒ Example of the tension between role of an external consultant as advocate for their client and servant of the public interest ⇒
  - Example of a litigation that was an attempt to impose a form of GK liability on an economic consulting firm (Lexecon), which had provided services for Lincoln Savings.
  - Plaintiffs argue that Lexecon had violated securities laws by misleading investors with respect to the safety of some securities.
- **Deloitte example ⇒ NY State Department of Financial Services**

- Deloitte performed some consulting work for Standard Chartered Bank – compliance with money laundering and regulations restricting the provisions of services or entities subject to US economic sanctions.
- Deloitte shared some confidential supervisory information in its possession about another bank
- Settlement ⇒ Parties (Deloitte and DFS) agree that ⇒
    - **Deloitte violated NY Banking Law and its own polices by knowingly disclosing confidential supervisory information to SCB regarding other Deloitte client banks.**
        - Deloitte disclosed 2 reports that contained supervisory confidential information – firm lacked authorization to disclose such reports.
    - **Deloitte will pay $10 million.**
    - **Deloitte will establish the procedures and safeguards set for the in the settlement to raise the standards to independent financial service consultants** (within 12 months) ⇒ some of them are ⇒
        - Better transparency;
        - Disclosure;
        - Maintain an open line of communication with the DFS;
        - Maintain confidentiality of bank supervisory material;
        - Comprehensive training programs;
        - Draft a handbook as guidance relating to confidential supervisory information and how such materials should be handled.
    - For 1 year Deloitte will not accept any new engagement that would require the Department to approve Deloitte as an independent consultant or to authorize the disclosure of confidential information under NY Banking Law.

<u>INFORMATION SECUTIRY (CHAPTER 11)</u>:

A. **<u>Introduction</u>:**

- Most organizations compile, **maintain and analyze large amounts of information, most of which are in public records**.
- **Information not contained in public records is "non-public information"**.
- **Non-public information is protected by law against their acquisition by unauthorized persons**.
- Features that distinguish non-public information:
  (i) Harm that is **likely to occur if the information is revealed** (e.g. a person's sexual preference).
  (ii) Harm that is likely to occur to others if the information is <u>not</u> disclosed (e.g. whether a person is a sexual offender).
- **The importance of protection of non-public information has become more pressing because the developments in technology, which allow easily store large amounts of information and its rapid transmission**.
- Data security now faces more threats such as:
  (i) Employee negligence.
  (ii) System glitches.
  (iii) Vandals or hacktivists.
  (iv) Domestic enemies.
  (v) Fraudsters.
  (vi) **Hostile foreign governments**.
- ATP1 case – discovery that there was a huge center in China dedicated to illegally obtain information of the US. There are allegations that the Chinese government were involved in this case.
- **The risks of breaches are increased by the use of vendors**

B. **<u>Financial Institution Regulators</u>:**

1. <u>Gramm-Leach-Bliley **Act §501**</u>:

*(a) It is the policy of the Congress that each **financial institution has an affirmative and continuing obligation to respect privacy of its customers and to protect the security and confidentiality of those customer's nonpublic personal information**.*
(b) Financial institutions safeguards:
In furtherance of the policy in subsection (a) of this section, each [federal financial institution regulator], other than the Bureau of Consumer Financial Protection, shall establish appropriate standards for the financial institutions subject to their jurisdiction relating to administrative, technical and physical safeguards–

*(1) **to insure the security and confidentiality of customer records and information;***

*(2) **to protect against any anticipated threats or hazards to the security or integrity of such records; and***

(3) to protect against unauthorized access to or use of such records or information which could result in substantial harm or inconvenience to any customer.

- The Federal Financial Institution Examination Council (umbrella organization of financial institution regulators) **has established two general rules to implement §501:**
  - (i) **Privacy Rule: prohibits a financial institution from disclosing a consumer's nonpublic information** to a non-affiliated third party unless certain notice requirements are met and the consumer does not opt out of the disclosure.
  - **(ii) Security Guidelines: establish standards relating to administrative, technical and physical safeguards for customer information.**

2. Federal Financial Institution Examination Council, Interagency Guidelines Establishing Information Security Standards:

- Each financial institution must:
  - (i) **Develop and maintain an effective information security program tailored to the complexity of its operations**; and
  - (ii) **Require, by contract, service providers that have access to its customer information, to take appropriate steps to protect the security and confidentiality of this information**.
  - (iii) **Identify and evaluate risks to its customer information, develop a plan to mitigate the risks, and implement, test and update the plan** when necessary.
- **Customer information is defined as any record containing nonpublic personal information**
- A risk assessment must include the following steps:
  - (i) **Identifying reasonably foreseeable internal and external threats**.
  - (ii) Assessing the **likelihood** and potential damage of identified threats.
  - (iii) Assessing the **sufficiency of the policies,** procedures, customer information systems, and other arrangements in place.
  - (iv) Applying each of the following steps in connection with the disposal of customer information:
    - Identifying reasonable foreseeable internal and external threats.
    - Assessing the likelihood of potential damage of identified threats.
    - Assessing the sufficiency of policies and procedures.
    - **Hiring an outside consultant to conduct the risk assessment**.
    - Engaging in an ongoing risk assessment process.
    - Designing security controls. Institutions should adopt the following if appropriate:
      - o Access controls on customer information systems.

- o Access restrictions at physical locations containing customer information.
  - o Encryption of electronic customer information.
  - o Procedures designed to ensure that customer information system modifications are consistent with the institution's information security program.
  - o Dual control procedures, segregation of duties, and employee background checks for employees with responsibilities for or access to customer information.
  - o Monitoring systems and procedures to detect actual and attempted attacks.
  - o Response programs that specify the actions to be taken when the institutions suspects or detects that unauthorized individuals have gained access to customer information systems.
  - o Measures to protect against destruction, loss or damage to the information.
  - o Ensure that paper records are rendered unreadable.
  - o Implement additional disposal techniques for electronic sensitive data.
- **Develop and implement a response program**. Components of an effective program include:
  - o Assessment of the nature and scope of the incident and identification of what customer information was accessed or misused.
  - o Prompt notice to its primary federal regulator.
  - o Notice to appropriate law enforcement authorities.
  - o Measures to contain and control the incident to prevent further unauthorized access.
  - o Notice to customers when warranted.
- **Circumstances for customer notices. If there is or will be misuse of sensitive customer information, the institution must provide notice.** Sensitive information includes name, address, or phone number, in conjunction with social security number or a personal identification number or password that would permit access to the customer's information.
- **Training staff.**
- **Testing key controls.**
- **Overseeing service providers**. An institution must:
  - o Exercise appropriate due diligence in selecting service providers and require them by contract to implement appropriate measures designed to meet the objectives of the Security Guidelines.
  - o Monitor service providers to confirm they satisfy their obligations under the contract.
- Contracts with service providers. They should include that they:

- Implement appropriate measures designed to protect against unauthorized access to or use of customer information.
- Properly dispose customer information.

- **Monitoring service providers**.
- Adjusting the program.
- Responsibilities of and reports to the BoD. The BoD must approve the written information security program, and must oversee its implementation and maintenance.

3. Federal Financial Institution Examination Council (FFIEC), Interagency Guidance on Response Programs for Unauthorized Access to Customer Information and Customer Notice:

- Components of a **response program**:
  (i) **Assessing the nature and scope of an incident** and identifying what customer information have been accessed or misused.
  (ii) **Notifying its primary federal regulator** as soon as possible.
  (iii) **Filing a timely Suspicious Activity Report**, and when federal violations are involved, to promptly notify the appropriate law enforcement authorities.
  (iv) **Taking appropriate steps to contain and control the incident**.
  (v) **Notifying customers when warranted**.
- Sensitive customer information: name, address or phone number in conjunction with social security number, driver's license number or password that would permit access to the customer's account.
- Notice to be provided to customers: required when the institution becomes aware of an incident of unauthorized access to customer information and, after reasonable investigation, determines that misuse of the information occurred or it is reasonably possible to occur.
- **Customer notice: should be given in a clear and conspicuous manner**, including the following items:
  (i) **Description of the incident**.
  (ii) **Type of information affected**.
  (iii) **Measures taken by the institution**.
  (iv) **Phone number customers can call for assistance**.
  (v) **Remind customers to remain vigilant for the next 12-24 months**.
- Delivery of notice: should be made in a manner designed to ensure that the customer can reasonably be expected to receive it.

C. **Medical Records and HIPAA:**

- **The Health Insurance Portability and Accountability Act ("HIPAA") requires healthcare entities to protect the confidentiality of protected health information** ("PHI") which is personal medical information, including name, address, social security number, and all medical information. Covered entities are subject to civil or criminal penalties if they improperly handle or disclose PHI.

- The Department of Health and Human Services has implemented HIPAA's data protection provisions mainly through:
  (i) The **Privacy Rule**, 45 C.F.R. §§164.500-164.534, dealing with all media in which health-related information is stored; and
  (ii) The **Security Rule**, 45 C.F.R. §§164.302-164.318, dealing with electronic medical information.
- The Security Rule specifies administrative, physical and technical security safeguards, and implementation specifications for each. The following Administrative safeguards are required:
  (i) **Implement policies and procedures to prevent, detect, contain and correct security violations**.
  (ii) **Identify the security official who is responsible for the development and implementation of policies and procedures**.
  (iii) Implement policies and procedures to ensure that all members of its workforce have appropriate access to electronic protected health information, and to prevent those workforce members who do not have access from obtaining access to electronic protected health information.
  (iv) **Implement policies and procedures for authorizing appropriate access** to electronic protected health information.
  (v) Implement a security awareness and training program for all members of its workforce.
  (vi) **Identify and respond to suspected or known security incidents; mitigate** harmful **effects or** security incidents that are known to the covered entity; and document security incidents and their outcomes.
  (vii) Establish policies and procedures for responding to an emergency or other occurrence that damages systems that contain electronic protected health information.
  (viii) **Perform a periodic technical and nontechnical evaluated**, based initially upon standards implemented under this rule and subsequently, in response to environmental or operational changes affecting the security of electronic protected health information.
- **The Security Rule allow the use of vendors to create, receive, maintain or transmit electronic protected health information on behalf of the covered entity, if the covered entity obtains satisfactory assurances that the vendors will appropriately safeguard the information.**
- **There is no private cause of action under HIPAA**. However, note the case of **Acosta v. Byrum (2006):**
  (i) Facts:
    - Plaintiff was a patient of Psychiatric Associates ("PA"). She was also employed by PA during 2003-2004.
    - PA was owned by Dr. Faber and Byrum was the manager.
    - Plaintiff alleges that Dr. Faber improperly allowed Byrum to use his medical access number, which allowed Byrum to retrieve the plaintiff's confidential psychiatric and other medical and health care records. Byrum provided such information to third parties without authorization or consent.

- Plaintiff alleges that Dr. Faber violated HIPAA by providing Byrum with his access code, and that he knew or should have known that exposure of her information could result in damages to plaintiff.
- Dr. Faber filed a motion to dismiss which was granted and the plaintiff appealed.

(ii) Decision: the dismissal was improper because the plaintiff did not use HIPAA as a cause of action.

(iii) Rationale:
- Plaintiff argued that Dr. Faber had negligently inflicted emotional distress.
- **The negligence was evidenced by Dr. Faber allowing Byrum to use his access code which would be an action prohibited under HIPAA.**
- **HIPAA was raised in this case only to prove the standard of care that Dr. Faber should have observed in this case.**

(iv) Additional comments: note that in I.S. v. Washington University (2011) the court upheld a negligence claim under state law and indicated that the reference made to HIPAA in such case did not state a separate claim for relief, but did provide "the standard of care by which to adjudge the defendant's actions".

D. **<u>Consumer Information</u>:**

- **Federal Trade Commission, In the Matter of Dave & Buster's, Inc. ("D&B"):**

(i) D&B owns and operates restaurant and entertainment complexes in the U.S. In conducting business, they collect customer's information for authorizing payments cards, including credit card number, expiration date and electronic security code.

(ii) At least since April 2007, D&B failed to have appropriate security systems.

(iii) **Exploiting the system's vulnerabilities, an intruder obtained personal information related to the credit cards which resulted in approximately 130,000 credit card compromised in the U.S**.

(iv) **D&B is ordered to establish, implement and maintain a comprehensive information security program**

(v) **D&B must obtain biennial assessments and reports from a qualified, objective, independent third party professional**, who uses procedures and standards generally accepted in the profession.

- Note that companies are reluctant to disclose security breaches because it normally bring bad reputation to them. However, there are manners in which companies can present the breach so that consumers are not discouraged from continuing to use their products/services.

E. **<u>Public Company Information</u>:**

- **Securities Exchange Commission, Cybersecurity**:

(i) Acknowledges the increased amount of cyber-attack cases.

(ii) **Victims of successful cyber-attacks may incur in substantive costs and suffer other negative consequences such as:**
- Liability for stolen assets or information and repairing system damage that may have been caused.
- Costs related to incentives offered to consumers or business partners in an attempt to keep such relationships.
- Increased cyber-security costs.
- Lost revenues for misuse of proprietary information.
- Litigation.
- Reputational damage.

(iii) **There are no disclosure requirements explicitly addressing cyber-security and cyber-incidents**, however, information regarding such cases should be **revealed insofar as it may be required to understand the nature of other disclosures that the company may have made in connection with protection of private information**.

(iv) **Risk factors: risks of cyber-incidents should be disclosed if they would be relevant factors to be considered by third parties when making an investment in the company**.

(v) **Management's discussion and analysis of financial condition and result of operation** ("MD&A"): **cyber-security risks and cyber incidents should be addressed in the MD&A if the costs or other consequences associated with known incidents or the risk of potential incidents represent a material event**, trend or uncertainty that is reasonably likely to have a **material effect** on the registrant's results of operations, liquidity, or financial condition or would cause reported financial information not to be necessarily indicative of future operating results or financial condition.

(vi) Cyber incidents discovered after the closing of the balance sheet but before the issuance of the financial statements a disclosure may be required. If the incident constitutes a material non-recognized subsequent event, the financial statements should disclose the nature of the incident and an estimate of its financial effect, or a statement that such an estimate cannot be made.

F. **<u>Law Firm Information</u>:**

- **The issue of data security in law firms has grown recently since most law firms store client information electronically and lawyers have access to such information from different electronic devices.**
- **ABA Model Rule 1.6(c) requires that "a lawyer shall make reasonable efforts to prevent inadvertent or unauthorized disclosure of, or unauthorized access to, information relating to the representation of a client".**
- Comments 18 and 19 to Rule 1.6 establish the following:

(i) Unauthorized access or inadvertent disclosure of client information does not constitute a violation of the lawyer has made reasonable efforts to prevent the access or disclosure.

(ii) Factors to consider whether reasonable efforts have been made, include:
- Sensitivity of the information.
- Likelihood of disclosure if additional safeguards are not employed.

- Cost of employing additional safeguards.
- Difficulty of implementing the safeguards.
- Extent to which the safeguards could adversely affect the lawyer's ability to represent clients (e.g., software which are difficult to use).

(iii) **When transmitting client information, the lawyer must take reasonable precautions to prevent the information from coming into the hands of unintended recipients.** This duty does not require that the lawyer uses special security measures if the method used offers reasonable security.

- Also, note the recent amendment to Model Rule 1.1. Comment 8: "to maintain the requisite knowledge and skill, a lawyer should keep abreast of changes in the law and its practice, *including the benefits and risks associated with relevant technology*…" This does not impose a new obligation on lawyers but serves as evidence of the concern of the use of technology and the ethical duties of lawyers.
- State Bar of Arizona Ethics Opinion 05-04 (2005):

(i) Attorneys and law firms are obliged to take competent and reasonable steps to assure that the client's confidences are not disclosed to third parties through theft or inadvertence. They are also obliged to take reasonable and competent steps to assure that the client's electronic information is not lost or destroyed. Lawyer who cannot do so are ethically required to retain an expert consultant who does have such competence.

(ii) Facts: the Inquiring Attorney has kept client files electronically in a computer system only accessible at the law firm. The firm now wants to change the system and allow attorneys and staff to access client information through the internet from a computer outside the physical offices of the firm.

(iii) Question: How do the firm protects the confidentiality and integrity of client information while continuing to increase reliance on internet for research, filings, communication and storage of documents?

(iv) Opinion:

- Stolen information: the modern rule is that precautions must be taken to prevent the theft of confidential communications to preserve the privilege.
- Inadvertent disclosure: generally, most operating systems contain firewalls that prevent unauthorized access to client information. Additional security measures could be employed such as adding passwords to, or encrypting the files. The decision of which software to use must be assessed by each attorney.
- Malicious destruction of client files: Most of the software mentioned above provide protection against destructive intrusions. Also, the practice of routine back-up of files should be put in place.

(v) Conclusion: **in order to comply with the ethical obligation of safeguarding client information and confidences, lawyers and law firms are obliged to take competent and reasonable steps to assure that the client's confidences are not disclosed to third parties through theft or inadvertence**.

- **Note on Cloud Computing** – See Pennsylvania Bar Association Committee on Legal Ethics and Professional Responsibility (Formal Opinion 2011-10):

(i) Cloud computing refers to **"offsite" storage of client data**, including in other jurisdictions with difference laws and procedures concerning access or destruction of electronic data.

(ii) Firms must ensure that the jurisdictions in which the date are physically stores do not have laws that would permit a breach of confidentiality.

(iii) As a consequence of the above, and provided that the third party vendor (in change of the cloud computing services) has access to confidential information, an attorney must take reasonable care to make sure that the conduct of the serviced provider conforms to the riles to which the attorney himself is subject to.

(iv) The standard of reasonable care in cloud computing includes:

- Baking-up data.
- Installing firewalls.
- Avoiding inadvertent disclosure of information.
- Verifying the identity of individuals to whom the attorney provides confidential information.
- Refusing to disclose confidential information to unauthorized individuals without client permission.
- Implementing electronic audit trail procedures to monitor who accesses the data.
- Creating plans to address security breaches.
- Ensuring that the provider has an enforceable obligation to preserve security.
- Investigating the provider's security standards.
- Having alternate ways to connect to the internet.

OFF-LABEL DRUGS (CHAPTER 12):

A. Background:

1. General comments:

- **The federal Food, Drug and Cosmetic Act (FDCA) provides that the Food and Drug Administration ("FDA") must approve a new drug for specific uses before it can be sold in interstate commerce. Drug manufacturers are not permitted to promote their products for non FDA-approved uses.**
- The problem of off-label drugs arises because **doctors may freely prescribe drugs for non-FDA approved uses.**
- Some "don'ts" of off-label marketing are described in the U.S. Department of Justice Press Release concerning a fine imposed to Eli Lilly for $1.415 billion for off-label drug marketing:
  - (i) The FDA approved Zyprexa for treatment of schizophrenia and bipolar disorder. Eli Lilly began encouraging doctors to prescribe Zyprexa to treat dementia, Alzheimer's agitation, aggression, hostility, depression and generalized sleep disorder.
  - (ii) Also, Zyprexa had side effects, included weight gain, which had been labeled by the FDA as "adverse effect" and yet Eli Lilly promoted them as effects with therapeutic benefits for those who had problems maintaining weight.
  - (iii) Eli Lilly promoted the non-approved use of Zyprexa firsts with physicians and later expanded its campaign by adding more sale representatives that were instructed to promote the non-approved use of the drug.

2. Information that drug companies may supply for publication in the media:

- FDA, Guidance for Industry: Responding to Unsolicited Requests for Off-Label Information About Prescription Drugs and Medical Devices (2011):
  - (i) Information distributed in response to an unsolicited request should be:
    - Provided only to the individual making the request directly to the firm as a private, one-on-one communication.
    - Tailored to answer only the specific question asked.
    - Truthful, non-misleading, accurate and balanced.
    - Scientific in nature.
    - Accompanied by the product label, scientific references, warnings and other information.
  - (ii) Responses to unsolicited requests of information should be generated by medical or scientific personnel independent from sales or marketing departments.

(iii) A firm should maintain record on all requests for information pertaining to off-label uses.

- Responses meeting the above requirements will not be used by the FDA as evidence of the firm's intent that its products be used for an unapproved use.
- Note that the same treatment is not provided to solicited requests, answers to which will most likely qualify as off-label marketing.
- When public requests are made, the FDA recommends that the firm's response be limited to providing the firm's contact information and should not include any off-label information.

3. <u>Publication of research results concerning off-label uses (FDA Practices)</u>:

- **A scientific or medical journal article that is distributed by a manufacturer should**:
  (i) **Be published by an organization that has an editorial board that uses experts; and that has a publicly stated policy of full disclosure of any conflict of interest or biases for all authors**, contributors or editors associated with the journal or organization.
  (ii) Be **peer-reviewed** and published in accordance with peer-review procedures of the organization.
  (iii) **Not be funded in whole** or in part by the manufacturers of the product that is the subject of the articles.
- **The scientific or medical publication should not be:**
  (i) **Primarily distributed by a drug or device manufacturer**.
  (ii) **Written, edited, excerpted or published specifically at the request of the manufacturer**.
  (iii) **Edited or significantly influenced by a drug or device manufacturer** or individuals having a relationship with the manufacturer.
- The publication should **address adequate and well-controlled clinical investigations that are considered scientifically sound by experts** with scientific training and experience to evaluate the safety or effectiveness of the drug or device.
- The journal reprint should be accompanied by a prominently displayed and permanently affixed statement disclosing:
  (i) That the uses described in the information have not been approved or cleared by the FDA.
  (ii) The manufacturer's interest in the drug or device that is subject of the journal.
  (iii) If the author is receiving any compensation from the manufacturer and the author's affiliations.
  (iv) Any person known to the manufacturer who has provided funding for the study.
  (v) All significant risks or safety concerns known to the manufacturer concerning the unapproved use that are not discussed in the journal.

4. <u>Promotion of off-label drugs and the 1st Amendment (U.S. v. Caronia, 2012)</u>:

- Caronia was a consultant hired to promote the drug Xyrem which is a dangerous drug known as "date rape drug" but it was approved by the FDA to treat severe cases of narcolepsy in adults.
- In 2005, the federal government launched an investigation focusing on the off-label promotion of the drug. Caronia was audio-recorded on two occasions promoting Xyrem for unapproved uses, including unapproved indications and subpopulations.
- **Caronia was found guilty of conspiracy to introduce a misbranded drug into interstate commerce.**
- Caronia appealed arguing that he was convicted for his speech (promoting the drug) in violation of his right of free speech under the 1st Amendment.
- **The Court of Appeals vacated the judgment and indicated that it rejects the government's invitation to construe the FDCA's misbranding provisions to criminalize the simple promotion of a drug's off-label use by pharmaceutical manufacturers and their representatives because such construction would run afoul of the 1st Amendment.**
- Dissenting: Caronia's intent was reveled through his speech, and the government has never been prohibited by the 1st Amendment to use speech as evidence of motive for intent.

B. **The Compliance Response:**

- **Companies have paid enormous fines for off-label marketing activities. Some employees have even faced criminal sentence.** These factors call for the establishing of a compliance program to avoid engaging in illegal activities.
- A well-designed and well-funded compliance program tends to negate criminal intent on part of the company and to introduce a more charitable attitude on the part of the FDA, prosecutors and juries.
- See the following relevant aspects of the **Corporate Integrity Agreement between the Office of the Inspector General of the Department of Health and Human Services and Cephalon, Inc.**

    (i) Chief Compliance Officer ("CCO"): shall be responsible for developing and implementing policies, procedures and practices designed to ensure compliance. The CCO must be a member of the executive management and shall make periodic reports regarding compliance, directly to the Audit committee of the BoD, and is authorized to report directly to the BoD o those matters. The CCO is not a subordinate of the General Counsel or the CFO.

    (ii) Compliance Committee: shall include at minimum the CCO and other members of senior management. The CCO shall chair the committee and the committee shall support the CCO in fulfilling his responsibilities.

    (iii) BoD: responsible for the review and oversight of matters related to compliance. It shall be responsible for:

    - Meeting at least quarterly to review and oversee the company's compliance program, including the performance of the CCO and the committee.

- Adopting a resolution on each reporting period summarizing the review of the company's compliance, and each member must sign the resolution.

(iv) Management accountability and certification: the company will have certifying employees who are specifically expected to monitor and oversee activities within their areas of authority and shall annually certify in writing that the applicable area of authority is compliant with the FDA requirements.

(v) Code of Conduct: must contain at least the following:
- The company's commitment to full compliance.
- The company's requirement that all of its covered persons are expected to comply with the corresponding regulations.
- The requirement that all covered persons are expected to report to the CCO or other appropriate individual of suspected compliance violations.
- The possible consequences to both the company and covered persons of failure to comply.

(vi) Third party personnel: third party personnel should be delivered with a letter stating the company's full commitment to compliance, with a description of the company's compliance program. The Code of Conduct must be attached to the letter.

(vii) Policies and Procedure: they must address:
- The subjects relating to the Code of Conduct.
- Appropriate ways to conduct Promotional and Product Services Related Functions in compliance with all applicable FDA requirements.
- The mechanism and the manner in which the company receives and responds to requests for information about non-FDA approved uses of its products.
- Development of call plans for field sales representatives who promote government reimbursed products.
- Consultant or other fee-for-fee service arrangements entered into with health care providers and institutions.
- Programs to educate field representatives.
- Sponsorship or funding of grants or charitable contributions.
- Funding of or participation in third party educational activity.
- Review of promotional materials by appropriate qualified personnel.
- Sponsorship or funding of research or related activities.
- Compensation for relevant covered persons.
- Disciplinary policies and procedures for violations of the company's Code of Conduct.

(viii) Disclosure Program: the company must have a disclosure program designed to facilitate communication relating to compliance with the applicable regulations and the company's policies. The program shall emphasize a non-retaliation policy, and shall include a reporting mechanism for anonymous communications for which confidentiality shall be maintained.

13. Foreign Corrupt Practices

1. **Spirit of the Foreign Corrupt Practices Act**
    a. Regulation coming from the corrupt practices revelations of 1970s
    b. Senate Report:
        i. Bribery is a bad business
        ii. In the free market system → competition is based on the quality and price of products
            1. Bribery alter this basis
        iii. Foreign corporate bribes alter domestic competitive climate
    c. **Two essential requirements of the FCPA**
        i. **Anti-bribery provisions**
            1. <u>Makes it an illegal practice "in order to assist in obtaining or retaining business," for a covered person corruptly to give or offer anything of value to any foreign official, politician, political party, or agent for the purpose of influencing an official act or omission, inducing such a person to influence a foreign government decision, or to secure any improper advantage</u>
                a. **Who is a foreign official?**
                    i. Answer seems clear → difficult when the person is employed by an entity, which, although not officially part of the government, is affiliated to it and carries out activities which may be associated with governmental functions
                b. **What nexus with the US is required to trigger the provisions?**
                    i. All US entities and individuals are covered, as are foreign nationals or entities that, directly or through an agent, engage in any act in furtherance of a corrupt payment while in the territory of the US
                        1. Any call, email, or fax made from, to or through the US could qualify as act to facilitate wire transfer of funds
                c. **Which acts qualify as having a business purpose?**
                    i. If a gift has a connection with the acquisition or retention of business → it may qualify for the purposes of the FCPA
                d. **When is a payment corrupt?**
                    i. The payment must be made to induce the recipient to misuse her official position
                        1. What about extortion?
                            a. US regulators recognize that a true extortion would not trigger the enforcement
                                i. i.e. imminent threat
                e. **What is necessary to complete the offence?**

        i. Just simple offer of bribe regardless whether the bribe is actually paid
    f. **What sort of consideration constitute "anything of value"**
        i. Chas, payment of personal expenses, gifts, personal favors
            1. No included
                a. Offering dinners or purchasing a cup of coffee
                b. Paying taxy
                c. Or items of merely nominal value will probably not reflect a corrupt intent
    g. **What is an improper advantage?**
        i. Not clear
    h. **Culpable state of mind?**
        i. The government approach is to assert that liability can be found on "willful blindness" or "conscious disregard" of facts that anyone in the defendant's position would believe to be the case
2. **Defenses**
    a. If the action in relation to which the payment is made, is essentially ministerial, the FCPA allows American businesses to pay small bribes to include only actions such as granting permits, processing papers such as visas or work permits, providing police, telephone, power, water or mail services, permitting inspections, paying to load or unload cargo, or protecting perishable products from deterioration
    b. Two affirmative defenses
        i. Payment in question is legal under the written law
            1. Not enough if it just an accepted business practice
        ii. Reasonable bona fide expenditures
            1. Such as travel or lodging expenses incurred by or on behalf of a foreign covered person, which are directly related either to the promotion, demonstration, or explanation of products or services, or to the execution or performance of a contract with a foreign government or agency

ii. Accounting provisions

1. Rule requires SEC reporting issuers to make and keep books, records and accounts that, in reasonable detail, accurately and fairly reflect an issuer's transactions and dispositions of the issuer's assets
    a. Requirements to maintain a system of internal accounting controls sufficient to assure management's control, authority and responsibility over the firm's assets
        i. Provision applicable only to Public Companies
            1. But can be extended to subs of PC, which can act as agents of the PC

- **iii. FCPA violations are enforced by the SEC and the Department of Justice**
  1. **Penalties can be severe:**
     - **a.** Sanctions
     - b. Debarment (loss of rights to do business with the federal government)
     - **c.** Loss of export licenses
     - **d.** Potential exposure from class action and shareholder derivative lawsuits
     - **e.** Professional fees and expenses
     - **f.** Reputational damages
- **iv.** Bribery of domestic officials even though not within the scope of the FCPA is a crime

2. UNITED STATES V. ESQUENAZI

11th circ. 2014

- a. FACTS
  - i. Defendant co-owned Terra Communication Corp., which purchased and resold cell phone minutes
  - ii. One of its main vendors is Telecommunications D'Haiti (Telco)
  - iii. Telco was owned by the Haitian central bank until privatized in 2009
  - iv. In order to reduce the amount of its debt to Telco, Terra paid money to Telco's Director of International Relations
- b. DECISION
  - **i. FCPA prohibits any domestic concern from making use of the mails or other means of interstate commerce in furtherance of a bribe to any foreign official or to any person, while knowing that all or a portion of such money or thing of value will be offered, given or promised, directly or indirectly, to any foreign official, for the purpose of influencing any act or decision of such foreign official In order to assist such domestic concern in obtaining or retaining business for or with, or directing business to, any person**
  - **ii.** Central question
    1. What's instrumentality?
       - **a.** District court sufficient evidences that Telco qualified as an instrumentality of the Haitian government
  - **iii.** Court's analysis
    1. Instrumentality is a mean or agency through which a function of another entity is accomplished, such as a branch of a governing body
    2. In the FCPA the instrumentality are agencies, departments, or entities through which the government performs its functions and that are controlled by the government
    3. From other words of the FCPA the court found that instrumentality means doing the business of the government
    4. What's the government business?
       - **a.** Defendant claims that it should be read narrowly

                    i. But the fact that a governmental entity provides a commercial service does not mean automatically that it is not instrumentality
                    ii. Court declined to limit the term only to entities performing traditional core governmental functions

        5. **Court defines instrumentality under the FCPA as an entity controlled by the government of a foreign country that performs a function the government as its own**
            a. What does control mean?
                i. Look at the government's formal designation of that entity
                    1. Whether the government has majority
                    2. Whether the government has the ability to appoint management and directors
                    3. If entity profits go to the government
            b. When an entity does perform an activity that the government treats as its own?
                i. To consider
                    1. Whether the public and the government of that foreign country generally perceive the entity to be performing a governmental function
                    2. Whether the entity has a monopoly
                    3. If the government subsidizes costs of the entity
                    4. If the entity provides services to large portion of the country
            c. Court found that Telco fell in the definition of instrumentality

3. **SEC – In the matter of Alcoa INC**
    a. Proceeding related to the breach by Alcoa of the FCPA in relation to the sale of aluminum to Aluminium Barhain (Alba), company controlled by the Kingdom of Barhain
    b. Between 1989 to 2009 Alcoa retained a consultant to act as its middleman in connection with the sale of alumina to Alba
    c. Relationship with consultant was shaped to generate funds that facilitated corrupt payment to Bahraini officials
        i. Series of companies owned by the consultant purchased alumina from Alcoa and then resold such alumina to Alba gaining a markup, which allowed him to retain money to bribe officials
    d. The commission payments to the consultant and the alumina sales to the consultant were improperly recorded in the Alcoa's books and records
    e. Employees of Alcoa were willfully blind to the high probability that the consultant would have used his commission to mark up and pay bribes
        i. Despite red flags GC approved agreement with consultant without any Due Diligence
    f. SEC found Alcoa liable for breach of FCPA

4. **Department of Justice Opinion**

a. Case of a Company acquiring 100% of a target currently held by a foreign listed corporation
b. Seller and the Target Company largely confined operations to foreign countries and never issued securities in the US and have had negligible business contract, including no direct sale or distribution of their product in the US
c. Purchaser undertook Due Diligence on the Target using an accounting firm
    i. Review brought up accounting weaknesses and poor recordkeeping
    ii. Money used for bribing foreign officials
    iii. None of the payments occurred in the US or through a US person or issuer
d. In light of the above, Purchaser started pre-closing steps to begin to remediate the Target's weaknesses
e. Upon closing of the acquisition the target would be integrated in purchaser's compliance structure within one year an integration schedule has already been prepared
f. Given the above circumstances
    i. DOJ decided not to take any enforcement
    ii. DoJ lacks of jurisdiction for the past
g. GUIDELINES IN CASE OF ACQUISITION:
    i. The DOJ encourages purchasers to:
        1. Conduct FCPA Due Diligence
        2. Implement the purchaser's code of conduct and anti-corruption practices asap
        3. Conduct FCPA training to the employees of the acquired company
        4. Conduct specific FCPA audit on the target

5. Morgan Stanley
a. DOJ announced that MS executive, Garth Peterson pleaded guilty to conspiring to evade internal controls that the firm was required to maintain under the FCPA
    i. Accused to circumvent internal control system to transfer property of building to himself and a Chinese public official with whom he was friend
b. Morgan Stanley had an effective control system and reminded many times to Peterson to comply with the FCPA
c. Considering that MS had constructed and maintained a system of internal control, which provided reasonable assurances that its employees were not bribing government officials, the DOJ declined to bring actions against MS

6. US DEPARMENT OF JUSTICE AND SEC – RESOURCE GUID TO THE US FCPA
a. Hallmarks of Effective Compliance Program
    i. Individual companies must tailor their compliance program on the basis of its business and size
    ii. There is no on-size-fits-all program
    iii. Compliance programs employing "check-the-box-system" are not efficient or effective
    iv. Main feature of an effective compliance program
        1. Commitment from the senior management and clearly articulated policy against corruption

    a. Compliance programs should only be strong on paper
    b. Commitment of the top management and directors is important
    c. They should show that the company dissuades employees from seeking profits in breach of FCPA

2. **Code of Conduct and Compliance Policies and Procedures**
    a. Company's code of conduct is often the foundation upon which an effective compliance program is built
    b. Codes must be clear and accessible
    c. DOJ and SEC will check if the company has adopted steps to keep the code of conduct updated and effective
    d. Important factor → presence of policies and procedures outlining responsibilities for compliance within the company, internal controls, auditing practices and documentation policies
        i. Policies must be tailored on the basis of the company's business
3. **Oversight, autonomy and control**
    a. In appraising a compliance program SEC and DOJ will consider:
        i. Whether a company has assigned resources for the oversight and implementation of the compliance program
        ii. Financial Resources should be provided to carry out the program
4. **Risk assessment**
    a. Assessment of risk is fundamental to developing a strong compliance program
    b. Performing identical DD is not effective
    c. DOJ and SEC give credits to companies implementing in good faith a comprehensive, risk-based, compliance program even if that program does not prevent an infraction in a low risk area because greater attention and resources had been devoted to a higher risk area
    d. In the event the risk increases → compliance procedures should increase as well
5. **Training and continue advice**
    a. Compliance program and procedures should be communicated to the employees and the organization
        i. Training programs useful
            1. Also web-training
        ii. Companies should also develop appropriate measures to provide guidance and advice on complying with the company's ethics and compliance program
6. **Incentives and disciplinary measures**
    a. Enforcement of the compliance program is fundamental

            i. DOJ and SEC would consider if the company has provided for sufficient disciplinary measures in the event of breach of the compliance program

7. **Third Party Due Diligence and Payments**
    a. Often third parties are used to conceal payments of bribes
        i. As part of the risk based DD, companies should understand the qualifications and associations of its third party partners, including its business reputation and relationships with foreign officials
        ii. Companies should have and understanding of the business rationale for including third party in the transaction
        iii. Companies should undertake some form of ongoing monitoring of third party relationships
8. **Confidential Reporting and Internal Investigation**
    a. An affective compliance program should include a mechanism for an organization's employee to report suspected actions without fear of retaliation
        i. Companies should have in place an efficient, reliable and properly funded process for investigating the allegation and documenting the company's response
9. **Continuous Improvement**
    a. A good compliance program should constantly evolve
    b. An organization should take the time to review and test its controls and it should think critically about its potential weaknesses and risk areas
10. **M&A – Pre-acquisition DD and Post-acquisition integration**
    a. In the context of M&A
        i. A company that does not perform any FCPA DD prior to an acquisition may face legal and business risk
        ii. Effective DD enables to evaluate the costs for breach of the FCPA that may be borne by the target
        iii. Company's commitment to compliance is taken into account by DOJ and SEC to take enforcement actions against acquiring issuer
        iv. DOJ and SEC also consider whether after the acquisition the company has extended and integrated the target into its controls and compliance system

7. **Avon 2010 – 10k**
    a. Avon engaged an outside counsel to conduct an internal investigation and compliance review focused on compliance with the FCPA
    b. Investigation conducted under guidance of the Audit Committee
    c. Avon voluntarily alerted DOJ and SEC of the investigation
    d. Internal investigation focused on expenses and books and records processes, including travel, gifts and use of third parties vendors, JV, payment to third parties agents related to business with foreign government

e. Various claim failed vs. officers and directors relating to the to company’s compliance with FCPA → outcome unclear

AML, BSA, OFAC, Chapter 14, p. 455 - 476

<u>Introduction:</u>

- **Criminals, terrorists and rogue states need financial services to carry out their activities**
- There is also the investment problem. **<u>To make investments the criminal need to use the services of a broker or other financial services firm</u>**.
- Terror organizations also have to use the **financial system in order to raise and transfer funds.**
- <u>The financial services sector therefore **is a key battleground in the fight against crime**, terror and state violators of human rights or international law</u>.
- The problem from the standpoint of the financial sector is that banks and other financial firms **have traditionally not concerned themselves very much with the nature of their clients' business.**
- As the example of BCCI's model shows, **governments cannot count on banks voluntarily and enthusiastically participating in law enforcement, anti-terror and international human rights activities. It is necessary to require them to cooperate**.

<u>Anti-money laundering/ bank secrecy</u>

- <u>The Bank Secrecy Act</u>: it was the first statute specifically aimed at enlisting banks in the fight against criminality. **It's principal concern was money laundering by organized crime organizations**
- The Act and its implementing regulations **require banks to file "Suspicious Activity Reports" ("SARs") with the Financial Crimes Enforcement Network ("FinCEN"), a bureau of the U.S. Department of the Treasury**.
    - These **reports are required whenever a transaction involves:**
        - At least **$ 5'000** and
        - **The bank knows, suspects or has reason to suspect that the transaction involves funds derived from illegal activities or is intended or conducted in order to hide or disguise funds or assets derived from illegal activities**
- **The Bank Secrecy Act is unusual in that it requires private firms to implement compliance programs**
- It is difficult for a bank to determine which of the transactions above $ 5'000 might involve illegal activities.
- Many forms of financial activity may give rise to suspicions of illegal activity, but some occur on a frequent enough bases to warrant being called out by the regulators.
- <u>FinCEN's list includes the following:</u>
    - FinCEN's Guidance on Preparing a complete & sufficient suspicious activity report:
    - <u>Examples of some common patterns of suspicious activity are:</u>
        - **A lack of evidence of legitimate business activity, or any business operations at all, undertaken by many of the parties to the transaction**
        - **Unusual financial nexus and transactions occurring among certain business types** (e.g. food importer dealing with an auto parts exporter)

        - **Transactions that are not commensurate with the stated business type** and, or that are unusual and unexpected in comparison with the volumes of similar businesses operating in the same locale
        - For more examples see p. 457, 458
- Once a bank has identified a suspicious activity, the next step is to report the matter to FinCEN. The agency facilitates the reporting task by providing an online filing system.
- The SAR form is the proper form to report such activity
- The most challenging as well as important part of the **requirements is the *narrative.* Only from the narrative the government gets a full picture of the nature of the banks concerns.**
- The narrative is the
    - Modus operandi of the subject committing the suspicious activity.
    - The bank must report in a concise, accurate, and logical manner containing the 5 "W's": Who, What, When, Where and Why?
    - Examples of good and bad narratives see p. 458 and 459

United States v. Wachovia Bank (2010)

- Beginning in June 2005, the U.S. Attorneys Office for the Southern District of Florida (DEA) (the drug enforcement administration) and the IRS began investigating certain wire transfers that were sent to the United States from Mexico.
- The wired funds were being used for the purchase of aircraft in the U.S. Those aircraft were then being used to move illegal narcotics from narcotics-producing countries for ultimate distribution in the U.S.
- The wire transfers were traced back to correspondent bank accounts held by certain Mexican currency exchange houses (CDC's)at Wachovia in the U.S.
- **During the investigation, law enforcement reviewed the CDC banking activity that occurred at Wachovia and found readily identifiable evidence and red flags** of large shale drug money laundering.
- Since the beginning of the BSA investigation **Wachovia has fully cooperated** and has provided valuable assistance to law enforcement.
- Since Wachovia's acquisition by Wels Fargo Wachovia has been subject to Wells Fargo's BSA/AML Compliance Program and compliance and operational risk management, oversight and independent testing.
- Eventually Wachovia **concluded a "deferred prosecution agreement" within a criminal case** (see p. 463).
- AML/BSA enforcement with compliance elements is also frequently observed in civil administrative proceedings.
- There is an example of such an agreement: "Board of Governors of the Federal Reserve System, Written Agreement by and Among M&T Bank Corporation, Manufacturers & Traders Trust Company and Federal Reserve Bank of New York on p. 464 ff.
- Table of Content/ Headings of that agreement are:
    - Firm-wide BSA/AML Compliance Program
    - BSA/AML Compliance
    - Customer Due Diligence
    - Suspicious Activity Monitoring and Reporting
    - Transaction Review

<u>The office of foreign assets Control ("OFAC")</u>

- **OFAC administers and enforces economic and trade sanctions against entities such as targeted foreign countries, terrorists, international narcotics traffickers, and those engaged in activities related to the proliferation of weapons of mass destruction**.
- **<u>OFAC regulation requires banks to block accounts and other property and to prohibit or reject unlicensed trade and financial transactions with specified countries, entities and individuals</u>**.
- Both OFAC and BSA/AML **require financial institutions to keep detailed records of their transaction**s for purpose of policing against the use of the financial system by bad actors
- A difference is that in the case of BSA/AML it is up to the bank to identify the suspicious party
- And **in the case of OFAC the bad actor is already identified**, giving the bank the task of **making sure it doesn't engage in a prohibited transaction with that person or entity**.
- Because OFAC and BSA/AML compliance issues are similar, they are often grouped together

  <u>The Role of Attorneys</u>

- Ill-gotten gains can be laundered through various means ranging from very simple to the very complex.
- Terrorist activities can be financed by straightforward means or by more indirect methods.
- Complex arrangements are more insidious because they are difficult to detect and punish.
- These are also arrangements that because of their complexity often call for the services of attorneys. **Thus lawyers play an important role, for good and bad, in the area of money laundering and terrorist finance**.
- **They can facilitate these activities by providing services to bad actors,** they can also help prevent or deter these activities by refusing to provide services or by cooperating in government law enforcement efforts.
- <u>The American Bar Association provides advice</u>
  - **"American Bar Association Task Force on Gatekeeper Regulation and the Profession, Voluntary Good Practices Guidance for Lawyers to Detect and Combat Money Laundering and Terrorist Financing**"
    - The purpose of the paper is to assist members of the legal profession in the U.S. in designing and implementing effective risk-based approaches to money laundering or terrorist financing.
    - The paper seeks only to serve as resource that lawyers can use in developing their own voluntary risk-based approaches
    - An overarching purpose of the paper is to encourage lawyers to develop and implement voluntary but effective, risk based approaches consistent with the Lawyer Guidance, thereby negating the need for federal regulation of the legal profession
    - What is the risk-based approach?
      - It is grounded in the premise that the limited resources (both governmental and private) available to combat money laundering should be employed and allocated in the most efficient manner

possible so that the sources of the greatest risks receive the most attention.
    - The proportionate nature of the risk-based approach means that higher risk areas should be subject to enhanced procedures, such as enhanced client due diligence (CDD) and enhanced transaction monitoring.
  - <u>What are the risk categories?</u>
    - Three major risk categories with regard to legal engagements are:
      - <u>Country/geographic risk</u>: there is no universally adopted listing of countries or geographic areas that are deemed to present a higher risk. But the high-risk countries include those that are subject to sanctions, embargos issued by the U.N. or others OR countries that lack appropriate anti-money laundering laws and regulations.
      - <u>Client risk:</u> Risk posed by the client. Clients can be individuals, corporations, etc. Higher risk client categories include:
        - Politically exposed persons
        - Unusual activity
        - Masking of Beneficial Ownership
        - Cash Intensive Businesses
        - Charities and NPO's
        - Financial Intermediariees not subject to adequate money laundering laws
        - Clients with criminal convictions
        - Clients with no address/multiple address
        - Unexplained change in instructions
        - Structures with no legal purpose
      - <u>Service risk:</u>
        - Some services are at higher risk for money laundering and terrorist financing. Typically those services involve the movement of funds and or the concealment of beneficial ownership.

<u>American Bar Association Standing Committee on Ethics and Professional Responsibility, Formal Opinion 463: Client Due Diligence, Money Laundering, and Terrorist Financing</u>

- The Model Rules of Professional Conduct and the ABA Voluntary Good Practices Guidance for Lawyers to Detect and Combat Money Laundering and Terrorist Financing ("Good Practice Guidance") are consistent in their ethical principles including loyalty and confidentiality.
- <u>The Good Practice Guidance provides information to help lawyers recognize and evaluate situations where providing legal services may assist in money laundering and terrorist financing</u>.
- **The rule does not mandate that a lawyer perform a "gatekeeper" role in this context.**
- Mandatory reporting is in conflict with Rules 1.6 and 1.18 and reporting without informing the client is in conflict with Rule 1.4(a)(5)

- The contours of a lawyer's obligation under the Model Rules of Professional Conduct with regard to efforts to deter and combat money laundering.
    - In August 2010 the ABA's policymaking House of Delegates adopted Good Practices Guidance, along with a resolution stating that the Association acknowledges and supports the U.S. Government's efforts to combat money laundering and terrorist financing.
    - The Good Practice Guidance is intended to serve as a recourse that lawyers can use in developing their own voluntary approaches.
    - <u>Good Practice Guidance is a policy that supports a</u>
        - Risk-based approach
        - This approach differs from a rules-based approach
        - It urges lawyers to assess money-laundering and terrorist financing risks by examining the nature of the legal work involved and where the business is taking place
    - **It would be prudent for a lawyer to undertake Client Due Diligence in appropriate circumstances to avoid facilitating illegal activity or being drawn unwittingly into a criminal activity.** This admonition is consistent with informal opinion 1470 (1981) where we stated that
        - "a lawyer cannot escape responsibility by avoiding inquiry. A lawyer must be satisfied on the facts before him and readily available to him, that he can perform the requested services without abetting fraudulent or criminal conduct and without relying on past client crime or fraud to achieve results the client now wants"
    - An appropriate assessment of the client and the client's objectives, and the means for obtaining those objectives, are essential prerequisites for accepting a new matter or continuing a representation as new facts unfold.
- The level of CDD varies depending on the risk profile of the client, the country or geographic area of origin, or the legal services involved.
- Furthermore clients who ask that the lawyer handle actual receipt and transmission of funds or those who request accelerated real estate transfers for no apparent reason may also require an extra level of scrutiny.
- Rule 1.16(b)(2) states that a lawyer may withdraw from representing a client if "the client persists in a course of action involving the lawyer's services that the lawyer reasonably believes is criminal or fraudulent".
- The usefulness of the Good Practices Guidance is an example of the declaration in the Model Rules that "the Rules do not…exhaust the moral and ethical considerations that should inform a lawyer…".

<u>Professor's up-date:</u>

<u>Deferred prosecution agreement **U.S. v. Barclay Bank, August 16, 2010**</u>

- based on the facts admitted to in the Factual Statement set forth below, <u>Barclays agreed to pay a fine of $149'000'000 to cooperate with the authorities in the investigation of other entities, and to upgrade its OFAC compliance program.</u>

- In exchange the government agreed to defer any prosecution for two years and if Barclays remained in compliance with the commitments contained in the agreement, to recommend dismissal of the charges at the clos of the deferral period.
- This factual statement is made pursuant to and is part of the Deferred Prosecution Agreements dated August 16, 2010 between the DOJ and Barclays Bank
  - o **From the mid 1990 though September 2006 Barclays violated both U.S. and New York State criminal laws by knowingly and willfully moving or permitting to be moved hundreds of millions of dollars through the U.S. financial system on behalf o hanks from Cuba, Iran, Syria etx. In violation of U.S. economic sanctions**.
  - o **In May 2006 Barclays voluntarily disclosed to OFAC four transactions that were made in violation of U.S. sanctions** and it commenced a limited internal investigation
  - o Barclays has provided **prompt and substantial cooperation** by sharing the results of its internal investigation with DOJ an DANY as well as with OFAC
  - o Barclays from the beginning on has taken full responsibility for its conduct.
  - o DOJ alleges and Barclays admits that Barclays' conduct as described violated TWEA. Specifically Barclays violated 50 U.S.C. app. §§ 5 and 16 which makes it a crime to willfully violate or attempt to violate any regulation issued under TWEA. Further allegations and admissions regard violations of the International Emergency Economic Powers Act IEEPA
  - o **Barclays has fully acknowledged and accepted responsibility for it conduct**. Barclays undertook a voluntary and comprehensive internal review of its historical payment processing and sanctions compliance practices. More than 175 employees were interviewed, more than one hundred million records were reviewed.
  - o Barclays reported all of its findings in a timely manner to DOJ, DANY and to the regulatory authorities. Barclays has at all time provided prompt and substantial cooperation.
  - o Barclays has taken voluntary steps to enhance and optimize its sanctions compliance programs

<u>Department of Justice Office of Public Affairs, **BNP Paribas agrees to plead guilty and to pay $ 8.9 Billion for the illegally processing financial transactions for countries subject to U.S. Economic Sanctions (June, 30, 2014)**</u>

- Over the course of 8 year BNPP knowingly and willfully moved more than $ 8.8 billion through the U.S. financial system on behalf of sanctioned entities
- **They used a sophisticated system of "satellite banks" set up to disguise both BNPP's and the sanctioned entities roles in the payments to and from financial institutions in the U**.S.
- BNPP will waive indictment and be charged in a one-count felony criminal information, filed in federal court in the S.D. of N.Y., charging BNPP with knowingly and willfully conspiring to commit violations of IEEPA and TWEA form 2004 – 2012.
- **BNPP has agreed to plead guilty for its criminal conduct**
- The plea agreement subject to approval by the court, provides that BNPP will pay total financial penalties of $8.9 billion, including forfeiture of $8.8 billion and a fine of $140 million.

<u>ETHICS, SOCIAL RESPONSIBILITY, AND CULTURE (Chapter 16)</u>:

A. **<u>Charitable Gifts</u>:**

- ***A.P. Smith Mfg. Co. v. Barlow* (N.J. 1953)**
  - A 300-employee parts manufacturer donated $1,500 to Princeton and cut its dividend from $4 to $3 per share. Shareholders sued.
  - This was a pretty obvious case of collusive litigation: A perfect small-business defendant, a perfectly respectable charity<u>, no evidence of personal gain on the part of the directors, and way too many big-name public intellectual defense witnesses to be a real dispute over $1,500</u>.
  - Common law argument: **Charitable expenditures can benefit corporations' business operations, both in terms of public perceptions and investing in the education infrastructure that creates new employees and consumers**.
  - Anti-Communist argument: Increased taxation of wealthy individuals has decreased charitable giving to private, nonprofit institutions. Corporations need to step in to fill the void. **If corporations can't donate to private universities, public universities will be dominant**… and that way leads *communism*. (They don't say it, but they come really close.)
  - **No suggestion whatsoever that the charitable gift was made to further the directors' personal interests.**
  - **Held: Public corporations can make charitable contributions to nonprofits**.

B. **<u>Public Benefit Companies</u>:**

- ***Benefit Corporations*** are a new trend over the past decade. States have passed statutes enabling the **charter of businesses that are expressly allowed to make charitable giving on an equal or greater priority than maximizing profits**.
- Shareholders renounce their legal ability to object to charitable or social activities. (Not that they have much of one anyway, these days, barring a showing of improper personal gain.)
- Also called "low-profit limited liability corporations" or "flexible purpose corporations."
- It's too early to know exactly how popular these will become or whether they will be able to compete with more traditional for-profit corporations.

-

C. **<u>Codes of Ethics</u>:**

- A ***Code of Ethics*** **is a formal statement, endorsed by the highest authority in the organization, of the firm's expectations regarding the conduct of employees and other constituents.**
- The point is **to encourage people affiliated with the firm to go beyond mere compliance with the law, and conduct business with a higher level of social consciousness.**
- As a general rule, codes of ethics are not legally binding on firms. Courts have held that they are an "aspirational" form of "puffery" that cannot create reliance in contract law.

- **Sarbanes-Oxley encourages firms to adopt codes of ethics. SEC regulations require public firms to either have a code of ethics or file a disclosure explaining why they don't have one.**

D. <u>Social Responsibility</u>:

- ***Corporate Social Responsibility (CSR)*** **refers to the concepts that corporations should seek to advance broader social objectives than just maximizing profit at all costs.**
- CSR is a voluntary, diverse grab-bag of causes and objectives that not all firms agree on.
- Two arguments in favor of CSR:
  - Being known as a corporate "good guy" is good for the bottom line.
  - Even if there's no PR benefit, it's still good for society.
- The textbook questions whether Chiquita's CSR policy is really about being a "good guy" as opposed to distancing itself from its predecessor's involvement in terrorism, torture, and death squads in Latin America during the 20th Century.

E. <u>Human Rights</u>:

- In ***Kiobel v. Royal Dutch Petroleum*** **(U.S. 2011)**, the U.S. Supreme Court held that the Alien Tort Claims Act (28 USC §1350**) cannot be used to sue corporations for human rights abuses overseas.**
- The UN Human Rights Commissioner says **corporations should use their governance programs to ensure respect for human rights.** They should **incorporate policies at all levels, including conducting due diligence on overseas counterparties**.
  - It's not clear how applicable this is to U.S. corporations. Many of the "human rights" include mid-century socialist things that aren't even guaranteed in many U.S. states now (e.g., collective bargaining).
- As a general rule, **U.S. corporations have no legal obligation to ensure that their overseas vendors and counterparties respect human rights**.
  - **One notable exception is §1502 of Dodd-Frank, which requires publicly-traded American firms to engage in due diligence with regard to conflict minerals from the D.R. Congo.**
  - Some states, such as California, have additional sanctions for firms that violate this.
  - Compliance with the conflict minerals rule is extremely onerous and burdensome in practice.

F. <u>Sustainability</u>:

- A ***Sustainability Policy*** **is a statement, adopted by the highest authority in the organization, setting forth the firm's commitment to sustainable projects, i.e. projects that "are consistent with the needs and interests of future generations."**
- ***Sustainability*** is a newer trend than CSR, and reflects the idea that a corporation should operate in a way that the environment could support its operations indefinitely.
- **Judd F. Sneirson, *Green is Good* (Iowa L. Rev. 2009)**

        - Sustainable operations cost firms more in the short term, but studies show that they make as much or more over the long run.
        - There are two different corporate approaches:
            - ***Triple-Bottom-Line*** – Corporate accounting processes should assess performance on three different levels: <u>Economic prosperity, environmental quality, and social justice</u>. Looking at all three helps to identify inefficiencies and areas for growth that go unnoticed if short-term profits were the only concern.
            - ***Gearing Up*** – <u>Corporations should increasingly scale up from (1) bare compliance to (2) meeting consumers' increasing expectations for sustainability, eventually (3) taking the lead by partnering with government and civil society to innovate. From there, they (4) integrate sustainability principles into their core business strategy, and possibly even (5) reengineer their entire markets to make sustainability a prerequisite for doing business in the sector</u>.
                - Nike subscribes to this framework, and is on Gear #4.
- It's not clear that environmental sustainability and "social justice" are always as compatible as sustainability proponents act like they are. What happens when you pay workers a higher wage, and they consume more fossil fuels as a result?
- Perfect sustainability is probably impossible (see: carbon footprints). How sustainable is sustainable enough?
- Do corporations which did tremendous environmental damage in the past (e.g., logging) owe society a greater commitment to sustainability now?

<u>WHEN COMPLIANCE FAILS (Chapter 17)</u>:

A. <u>Enron</u>:

- Enron was a natural gas pipeline firm that diversified its business in the 90's due to the actions of Kenneth Lay (Chairman) and became the sixth largest energy company in the world.
- **However, its profits were inflated and its financing structures were rife with fraud and conflicts of interest.**
- **SEC initiated and investigation and by 2001 Enron was in bankruptcy**.
- **The collapse of Enron was cause by a series of transactions performed with related entities (some owned by Enron's officials such as the CFO).**
- **participation from Arthur Andersen** (a large accounting firm), which then was reported to the BoD.
- There was a **huge lack of oversight from the BoD in Enron's transactions**.
- The BoD also failed in requesting to be provided for additional information to fully understand the complex transactions with the related entities.
- Also, the Compensation Committee failed to review the compensation that the CFO was receiving from the related entities in which he had participation.
- Another issue was Andersen's failure to bring to the attention of Enron's Audit and Compliance Committee the serious reservations that Andersen partners voiced internally about the related-party transactions.
- Although the outside counsel was not blamed for the Enron scandal, it is arguable that they could have brought a stronger, more objective and more critical voice to the disclosure process.

B. <u>Worldcom</u>:

- Worldcom was a long-distance telephone providers in the business of re-selling long distance capacity that it purchased on a wholesale basis from major long-distance carriers. **Later the company went public and grew aggressively through the acquisition of other companies**. Despite the difficult years that the telecommunications industry experienced, Worldcom continue to post impressive revenue numbers. **However, the growth was due to a large accounting fraud**. The company filed for bankruptcy in 2002.
- The **accounting fraud accounted for over $9 billion in false or unsupported accounting entries**. Several high officials were sentenced to prison.
- The fraud was largely **possible due to failure from whistleblowers to come forward, inadequate auditing by Arthur Andersen and deficient financial control systems**.
- **The fraud was mainly promoted by its CEO who maintained an aggressive growth policy in the company.** He presented a substantially false picture to the market, the BoD and most of its employees.
- The investigations results shows that the fraud was **implemented under the CFO's direction** and was carried by several employees who made or knew of entries that were not supportable, and prepared reports that were false or misleading.

- **the BoD acted very passively toward the operations conducted by the CEO and the CFO.**
- After the CEO's resignation, **Internal Audit undertook a review of the capital expenditures until determined that the capitalization of several entries were improper. After this, the BoD disclosed the findings to SEC and the publi**c.
- Andersen's failure to detect the fraud was because (i) **Andersen missed several opportunities that might have led to the discovery of the fraud; and (ii) Worldcom personnel maintained inappropriate controls over the information that Andersen needed, and event altered documents so that Andersen would miss the fraud**.
- Also, Andersen employed an **approach to it audit different from the "traditional audit approach"**. Andersen's approach in Worldcom was focused on whether the company had adequate controls I place to mitigate possible risks. This allowed Andersen to miss significant risks that already existed. The investigation shows that Andersen does not appear to have performed adequate testing to justify reliance on Worldcom's controls.
- Andersen concluded year after year that the **risk of fraud was no greater than a moderate risk**, and so it never devised sufficient auditing procedures to address this risk.
- It must be noted that **Andersen's responsibility is not relieved for having difficulties from obtaining relevant information from Worldcom's employees**.
- **The failure from the BoD (although unaware of the fraud) was not having a structure that would allow them to detect red flags**. In fact, the CEO controlled the BoD's agenda, discussions and decisions.
- **The Audit Committee members do not appear to have had sufficient understanding of the Company's internal financial workings or its culture**, and they devoted little timing to this role, meeting as little as three to five hours per year.
- Similarly, Internal Audit had been structured in ways that made finding the fraud more difficult, for it reported most aspects to the CFO.
- After the fraud was discovered, **Worldcom set in place remedial steps in order to ensure proper checks and balances within the company, among which are**:
  - (i) Active and independent BoD and Committees.
  - (ii) Corporate culture of candor in which ethical conduct is encouraged and expected.
  - (iii) Corporate culture in which advice of lawyers is sought and respected.
  - (iv) Compensation policies and practices that create incentives consistent with the interests of the company's shareholders.
  - (v) Expanded role of Internal Audit.
  - (vi) Integrated financial accounting and reporting systems to which all appropriate personal have access.
  - (vii) Formalized and well-documented accounting policies and procedures.
  - (viii) Open and candid dealings with the company's outside auditors.
  - (ix) Use of budgets and financial targets as benchmarks, rather than as drivers of reported financial results or influencing the accounting treatment of transactions.

C. **<u>Sexual Abuse by Priests</u>:**

- During the decade of the 2000s, reports of sexual abuse by priests of the Catholic Church surfaced in the US and elsewhere. A flood of lawsuits followed this reports of abuse, resulting in more than **$1 billion in settlement payments**. Several dioceses sought bankruptcy protection and the Church suffered significant reputational harm.
- The US Conference of Catholic Bishops commissioned a study performed by John Jay College of Criminal Justice which concluded the following:
  (i) Sexual abuse by priests increased from 1960s through late 1970s and later declined and continues to remain low.
  (ii) No single cause of sexual abuse of minors by priests could be identified.
  (iii) Priests were affected by the "increased levels of deviant behavior" that occurred in American culture such as drug use, crimes and changes in social behavior such as increase premarital sexual behavior and divorce.
  (iv) Many accused priests were experiencing increased job stress and social isolation at the time the committed acts of abuse, and did not have access to psychological or professional counseling.
  (v) Priests who were sexually abused by children were more likely to commit abuses.
  (vi) Church leaders preferred to deal with the problem in-house rather than referring cases to prosecutors.
  (vii) The media focused in bishops who were slow to act, thus "further perpetuating the image that the bishops as a group were not responding to the problem of sexual abuse of minors".

D. <u>General Motors Ignition Switch Scandal</u>:

- During 2014 it became public how GM had dealt with information in its possession concerning **defects in ignition switches on several of their models which caused airbags malfunctions, which in turn caused numerous accidents**.
- After the incident became public, **GM's newly elected CEO confirmed that GM had made a recall of the affected vehicles and was providing customers with the proper attention,** which included, besides the recall, assistance in providing customers with alternatives for having a vehicle while the recalled ones were being repaired.
- Also, GM's new CEO confirmed that **new standards were being put in place** within GM to ensure that both employees and board members had customer's safety as its main concern.
- Additional, certain modifications were made within the corporate structure of GM, which included creating the position of Vice President, Global Vehicle Safety.
- The **National Highway Traffic Safety Administration ("NHTSA") also commented on the GM case and stressed the fact that they had an aggressive and effective defects program with staff who is deeply and personally dedicated to their mission**. It must be noted that NHTSA's role in the GM is highly questionable since it was revealed that NHTSA had been informed in at least two occasions of the ignition switch problem.
- The **Report to GM's BoD (2014)** contains the following important details concerning the ignition switches problem:

(i) **There seems to have been a contradictory environment with respect to the company's policies.** On the one hand, safety was to be considered as a critical priority, but at the same time, watching and reducing costs was a primary concern.

(ii) Employees seemed reluctant to raise issues concerning GM's culture for fear of retaliation.

(iii) Employees were trained by legal staff in the manner in which safety reports should be prepared. It appears that the idea was **to avoid providing "material" to plaintiffs that brought suits against GM**, but it also appears to have had the effect of having reports undermining safety concerns.

(iv) Several witnesses indicated that **safety issues that were effectively raised, were in fact discussed among the appropriate committees, however, in the end no committee within the organization would take responsibility in resolving the matter**.

(v) When GM became aware of the ignition switch problem, **did not take immediate actions but rather it devoted a large period of time in trying to find the "root cause" of the problem**. The consequence of this decision was a significant delay in recalling the malfunctioning vehicles.

(vi) As a consequence of the above findings, the following **recommendation were made:**

- Ensure that the responsibilities of the Vice President of Global Vehicle Safety are appropriately defined to comprehensively cover safety issues.
- Ensure a direct or indirect reporting line to the Vice President of Global Vehicle Safety.
- Review the activities of all safety-related departments in order to identify areas where multiple groups have similar or overlapping functions regarding safety issues.
- Implement regular communications with employees about safety, and ensure that employees understand that they are responsible for raising safety issues that they become aware of.
- Enforce and promote the non-retaliation policy.
- Regularly communicate to suppliers the importance of safety.
- Explicitly communicate to employees that they should not be reluctant to classify issues as safety issue.
- Provide regular written or oral updated to the legal staff.
- Ensure that the legal staff plays a critical role in assisting with the identification, analysis and resolution of safety issues that have given rise to customer claims.

INTRODUCTION TO RISK MANAGEMENT

A. WHAT IS RISK?

Definition 1 (traditional approach**): The chance of something bad happening**
Definition 2 (modern approach): **The dispersal of possible outcomes**

B. WHAT IS RISK MANAGEMENT?

Risk management (RM), broadly understood, is any activity that an organization undertakes to deal with future uncertainties.

The RM function seems to have **substantial overlap with compliance**. **The compliance function is a form of RM**. How should organizations respond to the fact that RM and compliance appear to be two sides of the same coin? There are 3 approaches.

1. **Compliance and RM operate in discrete "silos" each with its own policies and procedures.** This approach is **problematic** because it ignores the similarities and sacrifices economies of scale.
2. **Compliance is part of RM Problem**: Attempt to merge existing operations within the organization **can be controversial, plus RM and compliance have different philosophies**: while RM can recognize all enterprises carry risk, compliance cannot accept that the company has an appetite for non-compliance (i.e., there is a zero tolerance policy).
3. **Compliance and RM functions should be coordinated but not combined**.

C. THE PUBLIC INTEREST IN RISK MANAGEMENT

Although it may seem that the task of RM is solely of interest to the organization, and therefore that it is not a good candidate for regulation, **there is public interest in RM. The reason is that costs and benefits of risks assumed by and organization are not entirely internalized and the public may be affected (i.e., externalities).**
Some examples of these externalities were the effects of the 2007-2009 financial crisis and the nuclear disaster in Fukushima.

As a result of this, regulators usually review a company's risk appetite and if anything sparks concern, the regulator is likely to raise the problem with management. Beyond this, regulators and legislators impose substantive controls to bear on risk–prohibiting or limiting activities, requiring disclosures of key policies, imposing risk adjusted capital regulations, etc.

D. ENTERPRISE RISK MANAGEMENT

Over the past decades many features of traditional risk management have undergone substantial transformation.

1. Definition of Risk

Traditional notion conceives risk as the chance of something bad happening. The modern approach sees risk as the dispersal of outcomes rather than simply the chance of a bad one. Given this new definition of risk, the goal of minimizing risk is not paramount, rather the focus is on determining how much risk the organization is willing to take on.

2. **Distribution od Responsibility for Managing Risk**

Historically**, the RM function was distributed across business lines. E.g. risk of product liability was managed by consumer products division. The benefit of this practice was that (i) responsibility was given to an officer who "owned" the risk in question, (ii) RM was allocated to the person who knew the most about the operation, and (iii) RM could be thoroughly integrated into day-to-day activities.**

This practice has fallen out of fashion because:

➢ **It sacrificed more than it gained**. When risk is combined with operations, the official charged with both responsibilities might be more attentive to the latter, either because operational issues require an immediate response or because the manager lacks an understanding or appreciation of how to conceptualize and manage risk. Further, allocating risk management to operating divisions does not necessarily generate optimal result because the incentives and philosophy of the line managers may not align reliably with the interests of the organization.

➢ **Also, dividing the risk ignores correlations across different parts of the company**: a risk that might seem acceptable in one division may be unacceptable for the other.

➢ Finally, **risk can fall through the cracks when managed on a siloed basis**, because no one takes responsibility for ensuring that the separate operations are coordinating their activities.

3. **Risk Mitigation Strategies**

Risk managers traditionally viewed the purchase of insurance as the preferred strategy for mitigating risk. The idea was to pay a third party to take on some of the risk (this includes hedging in financial markets).

Currently **RM does not focus so intensely on insurance. There are some alternatives which may be more efficient or less costly (self-insuring risk and implementing internal controls to reduce chance of adverse effect occurring).**

4. **Priority of the Topic**

Risk is today a central focus of board deliberations, so central that many companies have instituted board-level risk committees, created positions for chief risk officers, and developed substantial resources to the task of managing risk.

5. **Focus of Risk Assessment**

Traditionally, **RM looked at financial risks to the organization**. The more modern approach to risk management **focuses on non-financial risks as well**. In other words, RM currently focuses on any risk that can impact the organization.

6. Transparency of Risk and Risk Management

Traditionally, neither risk nor RM were transparent, either to the investing public, the regulators or the BoD. This was partly because the RM function was distributed within the different departments of an organization. **Today risk at many institutions is treated in a more transparent manner.** Given that a company's RM activities have important consequences for future performance, it is desirable that the process be open and well understood, at least to the senior managers who direct the organization's strategic decisions.

E. TYPES OF RISK

- **Credit risk:** Risk that **borrowers will not repay**. Finance economists have tried to develop a reliable measure. Today **credit ratings are the most common measure**.

- **Liquidity risk:** Risk that an organization **will not have access to the funds** it needs to pay its obligations

- **Market risk:** Risk of price **fluctuations in the assets which are actively bought and sold** by an organization.

- **Strategic risk:** Risk posed by **business decisions**.

- **Competitive risk:** Risk that other **companies offering competitive products or services will erode an organization's profits** or market share through aggressive marketing or lowering prices.

- **Regulatory risk:** Risk that laws or regulations **will change in a way** that will impact the organization's operations or results.

- **Reputation risk:** Risk that the **news about an organization will increase or decrease the esteem** in which the organization is held by constituencies or the public at large.

- **Asymmetric information risk:** Risk that BoD and management may not fully understand **what is going on in the organization they run**.

- **Operational risk: Risk of losses resulting from inadequate or failed internal processes**, people and systems or external events.

F. GOVERNANCE OF RISK

Wachtell, Lipton, Rosen & Katz, Risk Management and the Board of Directors

The board cannot and should not be involved in day-to-day RM. Directors should instead, through their risk oversight role, satisfy themselves that the RM processes designed and implemented by executives and managers are adapted to the board's corporate strategy and as functioning as directed.

Through its oversight role, the board can send a message to the company's management and employees that corporate RM is not an impediment to the conduct of business nor a mere supplement to a firm's overall compliance program but is instead an integral component of the firm's corporate strategy.

The board should also consider the best organizational structure to give risk oversight sufficient attention at the board level. This may include creating a separate RM committee.

The Delaware courts have developed a framework for the board oversight of RM in a line of cases dealing with alleged violations of fiduciary duty. **To avoid risk of *Caremark* liability, boards should ensure that the company implements appropriate monitoring systems tailored to each type of risk.** The board should periodically review these monitoring systems and ask management and/or consultants for an assessment of the system's adequacy. Directors should also involve the company's general counsel as appropriate with respect to fulfilling the board's duty to have effective monitoring systems. The board should be sensitive to red flags and yellow flags, investigating them and causing them to be investigated, and should document its monitoring and investigatory activities.

Chapter 19- Approaches to Risk Management Pages 547-572

Risk management techniques in common usage are adapted to and sometimes grow out of specific business lines or areas.

The following are some common examples:

Lawyers ⇒ have been managing risk forever

A. Data

All risk management techniques depend crucially in the acquisition, analysis and presentation of information.

For the decision maker to have necessary information, the data must be first compiled. The decision-maker is not going to be able or willing to sort through or understand the raw data. Someone must categorize and analyze the information so it can be presented to the decision-maker in summary form.

Presentation of data is also key.

An example of data available but wrongly presented which lead to a bad call was the ***Challenger space shuttle mission disaster***. The **shuttle was launched on an especially cold day when the information available should have signaled it was not recommended**.
First: The proper information must be used if the analysis is to be valid. In the case of the **Challenger, the relevant information had been complied, but it was not used: Launches without thermal distress were excluded on the erroneous assumption that they were not relevant.**
Second: **The challenger disaster illustrates the power – and also the danger – of graphic presentation of data**. Graphic presentation of data can mislead as well as enlighten.

Dashboards- Is the generic term of how the graphic presentation of data is often known within organizations.
Dashboards can be organized in several formats, pie charts, tables, histograms, maps, etc).

Professor Update-

Complex organization spend a lot of money and time thinking about optimal dashboard design (key instrument to track performance, identify risks, and formulating policy). Unfortunately, **officials tasked with crating the dashboards tend to fall into 3 traps:**

1. They may confuse **quantity with quality,** with the result that the **decision-maker is overwhelmed with detail**. (Staff preparing dashboard are usually worried they will be criticized for leaving something out and they rather include more than less).

2. Dashboard designers, like architects, sometimes fall for what seems sex or clever, without attending **sufficiently to whether the information being provided will serve its purpose**.
3. **Ownership over discrete dashboard elements should, if possible, be assigned to individuals within the organization and should be based on objective metrics**. Identifying the owner clearly assigns responsibility for the function involved and builds accountability for performance.

B. Risk appetite

A ***"risk appetite"*** **is a formal statement of the amount of risk that the board of directors is willing to take on.** It is not the risk per se that firms desire, but rather the return that cannot be achieved without accepting a certain level of risk. **It captures the idea of tolerance of risk.**
While an organization is willing to take on a certain level of risk (in order to achieve a given level of return), its appetite for risk is not unlimited; there are some strategies that simply carry to much risk to be accepted.

C. Implementing the risk appetite

Five steps are involved:

1. **<u>Compiling a risk inventory</u>**

Take an **inventory of the risks facing the organization**. A bank for example understands that one of its key challenges is to deal with the risk of borrower default; a food company understands that it must address the risk of spoilage.

In addition, **companies have to take into account emerging risks**. If risks are not recognized in advance**, it may not be possible to prevent their occurrence or to mitigate their impact when and if they arrive**.

2. <u>Assessing **inherent risk**</u>

Once a risk inventory is compiled, the organization can **quantify the inherent risk of each given activity**. The inherent risk of an activity **is simply the risk that the activity would pose for the organization if no efforts were undertaken to prevent or mitigate the risk.**

Inherent risk is measured by evaluating 2 variables:
Probability (likelihood) That the event will occur.
Magnitude (impact) Of the event if the event does occur.

3. **<u>Assessing controls and mitigation options</u>**

The next step is assessing control strategies and **mitigation options.**

Control strategies: Things an organization can do to prevent the risky event from happening in the first place; they reduce the likelihood of a bad event occurring.

Mitigation options: Things the organization can do to limit the costs if the risky event does occur; they reduce the magnitude of the event if it does take place.

Example: Risk of loss to a homeowner as a result of a storm damage;
Control strategy – Some measure that the homeowner uses to prevent damage if a storm occurs. For example hurricane window shutters.
Mitigation option – Purchase insurance that covers storm damage to the home.

In the case of complex organizations, leading control strategies include:

- **Lines of defense:** To prevent mistakes or violations of policy that could harm the organization.
- **Activity level management:** Reduces risk by reducing the amount that a company engages in a particular investment or line of business.

In the case of complex organizations, **leading mitigation options include:**

- **Policies of insurance**
- **Hedging transactions** reduce risk through offsetting investments that perform the opposite direction than the investment creating the risk.

4. <u>Assessing residual risk</u>

Residual risk **is the risk that remains in an activity once the organization has implemented measures to control or mitigate risk**.

Residual risk can be modeled on the **same heat map that risk managers use to evaluate inherent risk.**

A concrete example: **One important risk for drug manufacturers is the risk that they will be found liable for "off label" marketing of its product.** There is an inherent element of this risk, and a chance that if a company does nothing to stop it, its sale force will commit regulatory violations. **Then there are control strategies, such as the companies compliance program, and also mitigation options, the measures that may be available to mitigate the expected costs of violations by performing an internal investigation**, upgrading compliance operations, and cooperating with the regulators. The residual risk is the risk of off-label marketing violations after the risk management measures have been implemented.

5. <u>Accepting residual risk</u>

After all things considered and in light of the enterprise's risk appetite, the risk is something the company is willing to accept in order to achieve the benefits of the activity with which the risk is associated.

The five steps do not occur one after another, they occur more or less simultaneously, and are performed on an ongoing basis.

Ideally the process would be iterative, in the sense that the organization would search for the option that offers the greatest value to the company in light of its risk appetite. Senior managers can and should assess the full range of options before presenting questions to the board of directors for decision.

D. Black swans, fat tails and stress tests

Most organizations have in place a plan for dealing with normal times; the plan is usually simply to keep on doing what they are already doing. *Effective risk management*, however, requires that organizations also plan for unusual times and circumstances.

A ***black swan*** **event is one which is unanticipated** and unexpected but which has major consequences.

A ***fat tail*** **distribution is one where the probabilities of the tails-the extreme events- are higher than under the bell curve distribution**. In the wake of the financial crisis of 2007-2009 many have argued that financial markets obey a fat-tail distribution, meaning that extreme financial events – bubbles and panics-happen more often than would be expected under the normal distribution.

Stress testing **is the most effective way devised so far to deal with the risk of unexpected, high cost contingencies.** It is a scenario in which a model of an **organization is subjected** to unusual and challenging conditions and then evaluated for its performance.

The use of models for stress tests is a strength of the technique, but also a weakness. The strength of the technique is its ability to test the effects of stressed conditions before they occur in a simulation model. The weakness is that the results of the test are only as good as the model.

Another **key component of the stress test is the stressors chosen**. Many different stress scenarios may be chosen. For example, the organization may run stress tests for mild, moderate or severe conditions. A company that can withstand a mild or moderate stress scenario may not be able to survive a severe set of conditions.

A field were stress tests are crucial is the financial sector, especially after the financial crisis. For example, the liquidity stress tests essentially ask:

Stressors however have its limitations. **Models operate on the basis of assumptions and there is risk that the assumptions will be wrong. Also, designers of models may be too focused on past events and not taking into accounts the dynamic forces**, which may create new risks and new stresses in the future. Another danger is the possibility of the stress test to be rigged to generate an intended result.

E. Drilling down: Specific risk management strategies

In several areas, **particularly financial firms, quantified risk management strategies are utilized to control particular forms of risk. They rely on mathematical models, which are simplified versions of reality that seek to emulate**, intractable form, some features of the institutions being managed or evaluated.

The models with the greatest impact combine several features:

-They must be **quantitatively precise**: Given certain numerical inputs, the output of the model must be exact.
- The **inputs to the models must be limited in number and readily available**.
- The model should **be supported by intellectual credentials**.
- **The models should generate output that can easily be used in defined strategies for action and employed by people** who don't necessarily understand the underlying theory (e.g. traders)

Examples:

1. Corporate default estimation methods

The Altman's Z score has been used to determine the default probability of a corporate bond, loan or account receivable.

2. Black-Scholes option pricing formula

Used to determine how much an option is worth.

3. Value-at-risk models (VaR)

Broad metric of the market risk of assets. It is used to prevent portfolio managers from exceeding risk tolerances established in conformity with the organizations risk appetite.
Unlike Altman's Z or Black-Scholes option pricing model, VaR cannot be calculated by inputting parameters readily available from public sources, instead the owners of a VaR model must develop a model of the probability distribution of the portfolio being modeled. Although it requires work, it generates useful outputs once they are in place.

Professor's update:

Risk analysis at complex organizations is typically treated as a technical subject and analyzed with the infrastructure of logic, rationality and often mathematics. Should the more subjective or emotional factors be taken into account as well? There is a line of authors who believe that *"interdisciplinary inquiry into the role of emotion in human behavior sheds light on how risks are assessed, prioritized, and ameliorated, on how the category of risk is constructed, and on how that categorization affects the cognitive tools and approaches we bring to normatively complex problems"*

F. Model Risk

Mathematical models have power because they generate controlled and theoretically justified quantitative results that can be of immediate use to decision-makers. However, mathematical models have their **shortcoming.**

The following excerpt provides and example of bank regulator's recent thinking of the topic:

Board of Governors of the Federal Reserve System, Supervisory Guidance on Model Risk Management
April 4, 2011

Model risk can lead to financial loss, poor business and strategic decision making, or damage to a bank's reputation. Model risk occurs primarily for two reasons:

- The model may have **fundamental errors and may produce inaccurate outputs** when viewed against the design objective and intended business uses.
- The model **may be used incorrectly or inappropriately**.

A guiding principle for managing model risk is an "effective challenge" of models, that is, critical analysis by objective, informed parties who can identify model limitations and assumptions and produce appropriate changes.

Developing and maintaining strong governance policies, and controls over model risk management framework is fundamentally important to its effectiveness.
…As part of their overall responsibilities, a bank's board and senior management should **establish a strong model risk management framework** that fits into the broader risk management of the organization. The framework should include standards for model development, implementation, use, and validation.
These actions will set the tone for the whole organization about the importance of model risk and the need for active model risk management….

Internal audit's role is not to duplicate model risk management activities. Instead, its role is to evaluate whether model risk management is comprehensive, rigorous and effective.

Although model risk management is an internal process, a bank may decide to engage external resources to help execute certain activities related to the model risk management framework.

Department of the Treasury, Comptroller of the Currency, January 14, 2013
In the matter of JP Morgan Chase

…**The bank shall submit an acceptable written plan to ensure appropriate control over the market risk and price risk models of the bank ("Model risk management plan"…)**

This request is an effort to implement the guidance on model risk management for JP Morgan Chase.
One problem dealt in the order is the risk associated with nascent or outmoded models. In an organization like JP Morgan Chase there is always the chance that outmoded models will continue to be utilized. Conversely, as a model is developed it may come to be used by some in the organization before it has received an official sign-off form appropriate managers.

G. Rating agencies

Another approach is to "outsource" part of its risk management function by relying on external evaluations and analysis. Among the most important sources of risk analytics are the rating agencies, which asseses the chances that debtors will default of bonds. 3 rating agencies dominate the market: Moody's, Standards & Poor's and the Fitch Group.

They had enjoyed a lot of credibility and prestige until the events of the financial crisis of 2007-2009. In the aftermath, lawmakers took steps to reduce reliance on their opinions.

Dodd-Frank Act directs federal regulators to reduce reliance on credit ratings as inputs into regulatory action. The act deleted assorted statutory references to credit ratings; ordered regulators to replace references to credit ratings with alternative standards of creditworthiness and required each agency to report how it carried out its mandate. Important consequence American Banks are not allowed to conform to the Basel III capital agreement, which does include the use of credit ratings to determine the amount of capital required.

H. Government Risk Assessment

The Government plays an active role in risk assessment, both for purposes of designing risk-based regulatory strategies and for providing guidance to private firms carrying out their enterprise risk management function.

The Comptroller of the Currency (OCC) has been at the forefront of these efforts. It sponsors conferences for bank directors that focus on best practices to identify, measure, monitor and control risk.
OCC also operated a "National Risk Committee" which monitors the condition of the federal banking system and emerging threats to the system's safety and soundness.
The Financial Stability Oversight Council (FSOC), an entity created by Dodd-Frank, consists of federal financial regulators, state regulators and an independent insurance expert appointed by the President. It provides a comprehensive monitoring of the stability of our nation's financial system.

J. Behavioral-economic approaches to risk management

Classical economic theory assumes that economic agents act rationally in pursuit of their objectives. **Behavioral economic work states that people tend to behave in predictable but irrational ways**.

The modern discipline of risk management, **in general, endorses the classical economic view, that at least in the context of decision-making within complex organizations, people generally make rational choices**. Yet, the behavior displayed by financial institutions and their regulators in the lead-up to the financial crisis of 2007-2009 might give reason to doubt that premise.

Consider the following excerpt, which argues that financial markets and financial market regulation are subject to pervasive and systematically significant conceptual biases and that those biases played a role in the financial crisis of 2007-2009

Geoffrey Miller & Gerald Rosenfeld, Intellectual Hazard, How conceptual biases in complex organizations contributed to the crisis of 2008

The thesis of this article is that the crisis of 2008 was partially caused by a problem with the processing of risk-related information in complex organizations. **Actors in complex organizations failed to properly acquire, process, transmit, and implement key information pertinent to risk. We call this problem *"intellectual hazard"*…**

…**a variety of intellectual biases contributed to excessive risk-taking by financial institutions, poor performance by bank regulators, and severe policy mistakes** by the Federal Reserve, all of which contributed to the financial crisis of 2007-2009.

Chapter 20- When Risk Management Fails Pages 573-583

In this chapter, cases where risk management fails are considered. It analyses two general issues: **(a) what factors caused the risk management function to break down? And (b) what steps could or should have been undertaken to prevent the disaster before it occurred?**

A. UBS and the financial crisis

UBS took huge losses at the outset of the crisis as a result of improvident investments in subprime mortgages backed securities.

In 2010 UBS issued a transparency report, which identified the **following causes:**

1. **Growth strategy**

UBS had an internal corporate objective of becoming one of the top banks in the world in a variety of financial sectors. After it spun off its subsidiary Dillon Read Capital Management in 2005, it sought to quickly develop the same sort of business in-**house. The growth strategy was not systematically planned or implemented.**

2. **No balance sheet limits**

No limits in place for how large it could grow**. It grew too fast, specially by accumulating a portfolio of US mortgage backed securities, which caused equally huge losses when these securities lost value.**

3. **Low refinancing rates**

4. **Complacency**

It **falsely believed that its investments in subprime mortgage-backed securities were safe, based on their high credit rating and the fact that they were often backed by bond insurers**. It also believed that its holdings could be sold at any time in the market. Because it nurtured an overconfident attitude about its risks, UBS neglected to limit its exposure in the US housing market.

5. **No overall assessment of risk positions**

Failed to **make any overall assessment of the entirety of the bank's credit** and default risks associated with its portfolio of mortgaged backed securities.

6. **Reliance on information from business units**

Senior management relied on heads of business units who assured them that risk in the US housing market was under control.

7. **<u>Overreliance on statistical models</u>**

UBS risk control specialists relied too heavily on statistical models and paid too little attention to the fundamental risks underlying the US housing market.

8. **<u>Remuneration</u>**

Compensation practices at UBS did not distinguish good performance from income generated by exploiting market advantages, such as low funding costs. This incentive structure encouraged the generation of revenues without adequately considering the associated risks.

B. The London Whale

Permanent Subcommittee on Investigations, United States Senate, JP Morgan Chase Whale Trades; A case history of derivatives risks and abuses

In April and May 2012, **large trading losses occurred at JPMorgan's Chief Investment Office, based on transactions booked through its London branch**. **The unit was run by Chief Investment Officer Ina Drew, who has since stepped down.** A series of derivative **transactions involving credit default swaps (CDS) were entered**, reportedly as part of the bank's "hedging" strategy. **Trader Bruno Iksil**, nicknamed the *London Whale*, accumulated **outsized CDS positions in the market**. An estimated **trading loss of $6 billion** was announced. These events gave rise to a number of investigations to examine the firm's risk management systems and internal controls.

The **JPMorgan Task Force criticized both those who designed and implemented the flawed trading strategy and also those in management, including top bank officers, for having allowed the losses to occur. In its view:**

- Ina Drew the bank's Chief Investment Officer, **failed to ensure that the Chief Investment Office management understood and properly monitored the trades**, failed to ensure that internal controls functioned as intended, and failed to understand or appreciate the changes that occurred to the Synthetic Credit Portfolio.
- **Barry Zubrow head of the enterprise's risk management operation at the time of the trades, failed to properly control risk in the CIO operation.**
- Douglas Braunstein, the **Chief Financial Officer, did not correct the weaknesses in financial controls a**pplicable to synthetic credit portfolio, failed to question the changes displayed by the portfolio in 2012, and believed that the problems were primarily the responsibility of risk management rather than finance.
- As for Chairman and CEO Jaime Dimon, the Task Force diplomatically quoted the boss's self criticism: *"CIO, particularly the Synthetic Credit Portfolio, should have gotten more scrutiny from both senior management, and I include myself in that, and the firm-wide risk control function. These were egregious mistakes, they were self inflicted…"*

<u>Professors questions and comments on the London Whale fiasco</u>:

- The fiasco blew though the lines of defense. The traders and their supervisors failed to implement the correct strategy or apply proper controls; compliance and risk management did not detect the problem; an internal audit didn't notice anything amiss. Professor question why internal controls didn't work properly?

- Intellectual hazard? JPMorgan senior management appears to have had an idea that the Chief Investment Office in charge of the scandal was a stodgy, conservatively managed fixed income operation that did not pose significant risks, and exactly the opposite happens. Do managers act rationally.

C. Benghazi

Not all risk management breakdowns occur in the private sector. The government is also a complex organization subject to many risks. The following excerpt contains a report by a State Department review board of the vents surrounding the terrorist attacks in Benghazi, Libya which cost the lives of Ambassador Chris Stevens and 3 other US Government personnel.

In examining the circumstances of these attacks, the Accountability Review Board for Benghazi determined that:

1. The attacks were security related, involving arson, small arms and machine gun fire, and the use of RPGs, grenades, and mortars against U.S. personnel at two separate facilities…
2. Systemic failures and leadership and management deficiencies at senior levels within **two bureaus of the State Department (the "Department") resulted in a Special Mission security posture that was inadequate for Benghazi and grossly inadequate to deal with the attack that took place**.

   Security in Benghazi was not recognized and implemented as a "shared responsibility" by the bureaus in Washington charged with supporting the post, resulting in stove-piped discussions and decisions on policy and security. That said, Embassy Tripoli did not demonstrate strong and sustained advocacy with Washington for increased security for Special Mission Benghazi.

   The short-term, transitory nature of Special Mission Benghazi's staffing, with talented and committed, but relatively inexperienced, American personnel often on temporary assignments of 40 days or less, resulted in diminished institutional knowledge, continuity, and mission capacity.

   Overall, the number of Bureau of Diplomatic Security (DS) security staff in Benghazi on the day of the attack and in the months and weeks leading up to it was inadequate.

   The insufficient Special Mission security platform was at variance with the appropriate Overseas Security Policy Board (OSPB) standards with respect to perimeter and interior security. **Benghazi was also severely under-resourced with regard to certain needed security equipment, although DS funded and installed in 2012 a number of physical security upgrades**. These included heightening the outer perimeter wall, safety grills on safe area egress windows, concrete jersey barriers, manual drop-arm vehicle barriers, a steel gate for the Villa C safe area, some locally manufactured steel doors, sandbag fortifications, security cameras, some additional security lighting, guard booths, and an Internal Defense Notification System. Communication, cooperation, and coordination among Washington, Tripoli, and Benghazi functioned collegially at the working-level but were constrained by a lack of transparency, responsiveness, and leadership at the senior levels. Among various Department bureaus and personnel in the field, there appeared to be very real confusion over who, ultimately, was responsible and empowered to make decisions based on both policy and security considerations.

3. Notwithstanding the proper implementation of security systems and procedures and remarkable heroism shown by American personnel, those systems and the Libyan response fell short in the face of a series of attacks that began with the sudden penetration of the Special Mission compound by dozens of armed attacker.
4. The Board found that intelligence provided no immediate, specific tactical warning of the September 11 attacks. Known gaps existed in the intelligence community's understanding of extremist militias in Libya and the potential threat they posed to U.S. interests, although some threats were known to exist.
5. **The Board found that certain senior State Department officials within two bureaus demonstrated a lack of proactive leadership and management ability in their responses to security concerns posed by Special Mission Benghazi**, given the deteriorating threat environment and the lack of reliable host government protection. However, the Board did not find reasonable cause to determine that any individual U.S. government employee breached his or her duty.

<u>Professor's Update</u>

U.K. Financial Conduct Authority
Final Notice to Royal Bank of Scotland Plc. Et al.
November 19, 2014

This case illustrates the risks banks and many other institutions face in managing their information technology systems. **RBS was attempting to upgrade and outmoded system. During the upgrade the technicians detected problems with the new software and tried to revert to the older system. The damage was already done, the upgrade had created incompatibilities which interfered with the bank's ability to process consumer transactions**.

The incident sparked a management crisis. **Customers lost access to their checking accounts, failed to pay their mortgages, were unable to close on house sales, and the bank faced potential downgraded in credit ratings.** Some were stranded abroad without access to cash. IT systems collapses for days.

The bank was assessed fines of $88 million and paid approximately $111 million in redress to affected customers.

The problem was not a lack of financial commitment, the RBS Group was spending more then $1.5 billion each year to maintain it's IT infrastructure.

According to a report the bank failed to have adequate systems and controls in place to identify and manage their exposure to IT risks. In particular, Technology Services (office responsible), did not take the reasonable steps to ensure that changes to the bank's IT systems were carried out in a carefully planned and consistent manner. It did not manage and plan those changes adequately because it did not devise and implement adequate: process for identifying, analyzing and resolving IT incidents; and policies for testing software.