Enhanced Self-Policing During Turbulent Times: A Business Imperative for Corporate Entities Subject to the Securities Laws

by Colleen Doherty-Minicozzi

Strong self-policing is of critical importance to any risk management program administered by corporate entities subject to the federal securities laws. While preventing compliance problems in the first place is the central goal, it is equally important to the success of the business to promptly detect and resolve problems whenever they arise. Not only are specific types of self-policing legally required under the securities laws (e.g., for regulated entities, policies and procedures reasonably designed to prevent insider trading; for public companies, internal accounting controls),[1] but self-policing is also a business imperative, especially in volatile markets and financially troubled times, when incentives and opportunity for misbehavior multiply and the likelihood of being investigated and/or accused of transgressions of the securities laws increase.

During troubled financial times, corporate entities are more likely to be caught in the cross hairs of law enforcement investigations and prosecutions (whether by the SEC or criminal authorities). One does not need to look any further than the investigations and enforcement actions spawned by the subprime meltdown and the acquisition of Bear Stearns. Being able to point to a strong self-policing program and an environment that supports such a program is a critical legal, equitable, and policy defense for both the company and its senior officials who rely upon the controls in place. Accordingly, while self-policing is undoubtedly a cost center, it should not be viewed as a candidate for cost-cutting measures during turbulent times. In fact, it is during such times that additional focus should be placed upon self-policing to help minimize the heightened compliance risk.

Why is compliance risk heightened during troubled times?

While it seems like an obvious and indisputable statement that compliance risk is heightened during times of financial stress, it is worth focusing on why this is so since it helps to highlight the urgent need for increased diligence.

First, the incentive increases for corporate entities to engage in violative behavior because the bottom line is under stress.

Second, constituencies adversely affected by financial events (e.g., firm customers or shareholders) are more likely to complain and the law enforcement officials that protect their interests are spurred into action to investigate potential wrongdoing as well as to prosecute instances of alleged wrongdoing.

Third, during times of financial upheaval and significant business failures, compliance risk is heightened because areas of uncertainty in the law are more likely to be construed against corporate entities by law enforcement officials seeking to demonstrate government strength and responsiveness to perceived problems. The enforcement tools at the disposal of the civil and criminal authorities are amorphous and malleable in many respects and may be wielded by regulators to label a practice as violative without clear prior guidance or notice. The incentive to create law through enforcement actions is heightened during such times. Similarly, to demonstrate strength, law enforcement organizations are more likely to seek aggressive sanctions, an area in which they have wide latitude. In such a climate, it is politically unpopular to stand in the way of tough enforcement.

Does strong self-policing really get you anything if a problem is not prevented?

One tangible benefit to strong self-policing is that it can serve as a legal defense to a variety of primary and secondary liability charges for corporate entities in the civil context[2] and their officers, directors and supervisors in the civil and criminal contexts. For example, having a well-developed set of internal controls and procedures can help to defeat the state of mind requirement in a fraud claim under Rule 10b-5 of the Exchange Act or the anti-fraud provisions of the Securities Act or play a role in determining whether there is the requisite state of mind for controlling person liability under Section 20(a) or 21A of the Exchange Act or Section 15 of the Securities Act of 1933.

Even if the government determines that the self-policing does not provide a legal defense (and there is no appetite for litigation or a trial on the part of the entity), are there still tangible benefits to vigorous self-policing?

The government has said yes to corporate entities in the past and continues to say yes.

The SEC

In a June 4, 2008 speech at the Compliance Week Conference, Linda Thomsen, the Director of the SEC's Division of Enforcement noted: "As those familiar with the 2001 Seaboard Corporation 21(a) report issued by the Commission already know, it is a longstanding policy of the agency to credit entities for self-policing..."[3] According to that report, "[c]redit for cooperative behavior [including effective self-policing] may range from the extraordinary step of taking no enforcement action at all to bringing reduced charges, seeking lighter sanctions, or including mitigating language in documents the Commission uses to announce and resolve enforcement actions."[4]

Department of Justice

In its recently revised Principles

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of Federal Prosecution of Business Organizations, the Justice Department, while again making clear that an effective corporate compliance policy is not a legal defense for the corporate entity to criminal liability under the doctrine of *respondeat superior,* continued to leave open the possibility that a "truly effective compliance program . . . may result in a decision to charge only the corporation's employees and agents or to mitigate charges or sanctions against the corporation."[5]

United States Sentencing Guidelines: The sentencing guidelines, which only apply to the sentencing phase after liability is established, provide for a sentencing reduction for effective compliance programs: "[i]f the offense occurred despite an effective program to prevent and detect violations . . . subtract 3 points."[6]

This proposition that strong self-policing earns you credit with the government is inherently hard to measure. Regardless, a hallmark of a responsible corporate entity is strong self-policing. And, it is not worth the risk of having a weak self-policing program based on the view that a strong program does not garner credit. One of the prime benefits of such a strong program is prevention and deterrence. Moreover, a strong program may well limit the size of the identified problem on the front-end.

What's the good news?

Although compliance risk is an unavoidable consequence of engaging in activities governed by the securities laws, it is more manageable than many other forms of risk faced by an organization. Companies can readily identify the securities laws, regulations and rules to which they are subject and design individualized self-policing programs tailored to their size, nature and complexity. Companies can also seek to identify practices that, even if not definitively outlawed, may be viewed as problematic by the regulators. The government, without mandating what any particular set of procedures should include, has provided guidance on the core principles that form the foundation for any successful self-policing program.[7] Chief among those is that the program must be proactive in nature. The program, therefore, should take into account new and changing circumstances that affect the organization, whether company or industry specific or macro in nature such as general economic trends and market conditions. Accordingly, during troubled economic times, compliance programs should be kicked into high gear, which will benefit not only the entity but also its officers, directors and supervisors.

1. Registered broker-dealers and registered investment advisers are required to have policies and procedures reasonably designed to prevent the misuse of material, nonpublic information. Securities Exchange Act of 1934 § 15(f); Investment Advisers Act of 1940 § 204A. Under the Foreign Corrupt Practices Act, publicly traded companies registered with the SEC under the Exchange Act are required to "devise and maintain a system of internal accounting controls." Exchange Act Section § 13(b)(2)(B).
2. In the criminal context, corporations are strictly liability under the doctrine of *respondeat superior* for the crimes of their directors, officers, employees and agents if they were acting within the scope of their duties and if the criminal actions were intended, at least in part, to benefit the corporation. It is the Justice Department's position that an effective self-policing program cannot be a legal defense under the *respondeat superior* doctrine. United States Department of Justice, Principles of Federal Prosecution of Business Organizations, United States Attorneys Manual, Title 9, Chapter 9-28.800 (revised August 28, 2008).
3. Speech by Linda Chatman Thomsen, Director, Division of Enforcement, Remarks at Compliance Week Conference (June 4, 2008).
4. 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, Exchange Act Release No. 34-44969 (October 23, 2001).
5. Principles of Federal Prosecution of Business Organizations, Title 9, Chapter 9-28.800.
6. U.S. Sentencing Guidelines Manual § 8C2.5(f)(1) (2004).
7. *See, e.g., id.* at § 8B2.1; Principles of Federal Prosecution of Business Organizations, Title 9, Chapter 9-28.800.