

The Foundations of an Effective Ethics & Compliance Culture

*2019 CEFLI Compliance Leadership Forum
Nashville, Tennessee
September 11, 2019*



Discussion Topics

- Legal Foundations of Ethics & Compliance Programs
- Internal Control and Risk-Based Frameworks
- Corporate Misconduct and Organizational Culture
- Challenges in Aligning Ethics & Compliance Standards with Organizational Culture
- Promoting a Culture of Compliance

Legal Foundations of Compliance Programs

- Foreign Corrupt Practices Act
 - 1977 Federal law triggered formation of corporate compliance units
- Federal Sentencing Guidelines
 - Established elements of “effective” compliance in 1991 when organizational sentencing guidelines were added to prior guidance
- Key Legal and Regulatory Actions
 - In re Caremark International
 - W.R. Grace enforcement action
 - Multiple multi-state insurance regulatory task forces investigating misleading advertising, churning and deceptive sales practices
 - Vanishing premium class action litigation

Internal Control and Risk-Based Frameworks



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- COSO Internal Control—
Integrated Framework

- Sarbanes-Oxley Act
- Three Lines of Defense
- Enterprise Risk Management
- Increased Regulatory Monitoring of Risks



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Despite the well-established foundations for compliance programs, why does some corporate misconduct go undetected for years, resulting in major business scandals?



Recent Illustrative Examples

<p>Wells Fargo</p>	<p>“Fake Account” scandal in retail banking dating back to early 2000’s</p> <ul style="list-style-type: none"> - Up to 3.5 million fake accounts identified - Multiple settlements reportedly totaling close to \$ 3 billion 	<p>Initial Response: “Wrongful sales practice behavior goes against everything regarding our core principles, our ethics and our culture.” - John Stumpf, former Wells Fargo CEO testifying before Senate Banking Committee (9/2019)</p> <p>Subsequent Statement: “The root cause of the sales practice failure was the distortion of the [Bank’s] sales culture and performance management system...” - Independent Directors of the Board of Wells Fargo & Company: Sales Practices Investigation Report (4/2017)</p>	<p>2018-19 updates:</p> <ul style="list-style-type: none"> - In January, 2019, Wells Fargo announced it will take longer than expected to correct issues that led to sanctions imposed by the Federal Reserve in 2018. - Tim Sloan, CEO who replaced John Stumpf, unexpectedly resigned in March, 2019, shortly after facing criticism about the bank’s culture and sales practices during Congressional committee testimony. - In June, 2019, Wells Fargo agreed to pay at least \$385 million to settle a class-action lawsuit related to a scheme that forced auto-loan customers to pay for unnecessary and unwanted insurance.
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<p>VW</p>	<p>Diesel-rigging emissions scandal involving VW “clean-diesel” models sold in the U.S. from around 2007</p> <ul style="list-style-type: none"> - 11 million vehicles with VW diesel engines - Total cost of scandal exceeds \$33 billion 	<p>Initial Response: VW senior management claimed the plot to deploy control devices designed to defeat emissions testing in U.S., uncovered by independent testing in September, 2015, was entirely the work of a few lower-level employees.</p> <p>Subsequent Admission: In March, 2017, VW agreed to plead guilty to charges of conspiracy to commit fraud, and violations of the Clean Air Act by lying and misleading U.S regulators.</p>	<p>2019 updates:</p> <ul style="list-style-type: none"> - SEC filed suit in March, 2019, alleging that CEO Martin Winterkorn and numerous other senior officials knew of VW’s scheme to evade and defeat U.S. emissions tests at least seven years earlier than admitted to federal prosecutors handling 2018 guilty plea agreement. - VW settled with German prosecutors in June, 2019, paying a fine over \$ 1 billion. In August, Martin Winterkorn and four other former VW executives were indicted by German authorities on fraud charges related to the emissions-rigging scheme and subsequent cover-up.

Why do good people do bad things despite codes of ethics, business conduct standards, and routine compliance training programs?



Illustration by Adam Cole/NPR appears in May, 2012 web version of report titled: "Psychology of Fraud: Why Good People Do Bad Things"

Challenges in Aligning Ethics & Compliance Standards with Organizational Culture

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- Codes of ethics/business conduct can be perceived as external standards and are not internalized by the people who form the culture.
 - *SEC enforcement action against KPMG (June, 2019)*
 - *Five former KPMG auditors, including the partner in charge of audit quality, revised audit files in advance of inspections using internal, confidential information illegally obtained from former PCAOB employees.*
 - *KPMG auditors, including partners, engaged in a cheating scheme to share answers and/or manipulate exams that tested knowledge of accounting principles and regulations, required as a result of an earlier SEC enforcement action.*

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 - *SEC enforcement action against KPMG (June, 2019)*
- On the flip side, codes of ethics/business conduct geared to the demographics of the organization but not ingrained in leadership can backfire.
 - *Wayfair employee walkout and media/consumer fallout*
 - *Management at online home goods retailer, noted for attracting a youthful, tech-savvy workforce, declined employee requests to stop sales of goods to contractors operating detention camps for immigrants. Following a widely publicized walkout by over 500 employees at Wayfair offices, media and consumer activists decried management response, leading to reports that boycotts of Wayfair were being organized.*

Promoting a Culture of Compliance

Crafting the message....carrying the message



Appendix

Overview: Chapter 8 - Federal Sentencing Guidelines

- Establish standards and procedures of ethical conduct and compliance, including periodic assessment of the relevant risks and appropriate steps to reduce risks of noncompliance.
- Assign organizational roles and responsibilities: (a) Governing authority (knowledgeable about program content and operation; oversight with respect to implementation and effectiveness of the program); (b) Designated individuals within organization (overall responsibility for the program); (c) Individuals and resources shall be assigned to perform day-to-day functions and report periodically on the effectiveness of the program.
- Establish periodic communications on standards and procedures and other aspects of the program.
- Conduct appropriate training and education.
- Implement reasonable steps to (a) monitor and audit the program; (b) periodically evaluate the effectiveness of the program; (c) provide mechanisms for anonymous or confidential inquiries and reporting regarding potential compliance and ethics matters.
- Promote the program through appropriate incentives and enforce standards and procedures through appropriate disciplinary measures.
- Respond promptly to detected program gaps or violations, including modifications to improve program effectiveness or to prevent further noncompliance.

Note: Please review references in the Legal Foundations section of the Appendix for recent updates to published guidance.

Overview: Internal Controls and 3 Lines of Defense

- Internal control is “a process, effected by an entity’s board of directors, management and other personnel, designed to provide reasonable assurance of the achievement of the entity’s objectives.”
- Five key components of internal control:
 1. Control Environment—is a set of standards, structures, and processes that provide the foundation for performing internal control within the entity
 2. Risk Assessment—is a process used to identify, assess, and manage risks to the achievement of the entity’s objectives
 3. Control Activities—are actions performed under the direction of management, as directed by the entity’s policies and procedures, to mitigate the risks to the achievement of the entity’s objectives
 4. Information and Communication—is the distribution of information needed to perform control activities and to understand internal control responsibilities to personnel internal and external to the entity
 5. Monitoring Activities—are ongoing evaluations of the implementation and operation of the five components of internal audit
- Three lines of defense model:
 1. Operational Management: own and manage risks
 2. Risk Management and Compliance: oversee risks
 3. Internal Audit: independent assurance

References

• Legal Foundations

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- In re Caremark International, Inc., 698 A.2d 959 (1996), 1996 Del. Ch. LEXIS 125 (Del. Ch. Sept. 25, 1996)
- S.E.C. Release 34-39157, Report of the investigation pursuant to Section 21(a) of the Securities Exchange Act of 1934 concerning the conduct of certain former officers and directors of W.R. Grace & Co.: <https://www.sec.gov/litigation/investreport/34-39157.txt>
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Updated from 2018 CEFLI Conference

- U.S. Sentencing Commission, 2018 Guidelines, Chapter 8: <https://www.ussc.gov/guidelines/2018-guidelines-manual/2018-chapter-8#NaN>
[In particular, §8B2.1. Effective Compliance and Ethics Programs, plus commentary]
- U.S. Department of Justice: JM 9-28.000 Principles of Federal Prosecution of Business Organizations, Justice Manual: <https://www.justice.gov/jm/jm-9-28000-principles-federal-prosecution-business-organizations>
[In particular, §9-28.800 Corporate Compliance Programs, plus commentary, July, 2019 update]
- U.S. Department of Justice-Criminal Division: Evaluation of Corporate Compliance Programs, Guidance Document, Updated April, 2019: <https://www.justice.gov/criminal-fraud/page/file/937501/download>

• Internal Controls and Risk-Based Frameworks

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 - COSO Internal Control guidance: <https://www.coso.org/Pages/ic.aspx>
 - COSO Enterprise Risk Management guidance: <https://www.coso.org/Pages/erm.aspx>
- The Institute of Internal Auditors (IIA): www.theiia.org
 - IIA Sarbanes Oxley resources: <https://na.theiia.org/standards-guidance/leading-practices/Pages/Sarbanes-Oxley.aspx>
 - IIA Position Paper: “The Three Lines of Defense in Effective Risk Management and Controls”:
<https://global.theiia.org/standards-guidance/recommended-guidance/Pages/The-Three-Lines-of-Defense-in-Effective-Risk-Management-and-Control.aspx>
- Office of the Superintendent of Financial Institutions Canada (OSFI): RCM E-13: <http://www.osfi-bsif.gc.ca/Eng/Docs/e13.pdf>
- NAIC, Guidance on ORSA and CGAD: https://www.naic.org/cipr_topics/topic_own_risk_solvency_assessment.htm
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 - In the Matter of KPMG LLP, SEC Release 34-86118, June 17, 2019: <https://www.sec.gov/litigation/admin/2019/34-86118.pdf>
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THE FORUM THAT CONNECTS.



Compliance & Ethics Forum for Life Insurers

www.cefli.org