rules of compliance, but instead embrace both the letter and the animating spirit of the recent reforms.

## ORGANIZATIONAL ETHICS ARE ESSENTIAL TO LEGAL COMPLIANCE

We strongly endorse adoption of the Ad Hoc Group's recommendations, except as stated below, and greatly appreciated the thoroughness, thoughtfulness and insight of their report. The report states that "the Advisory Group is not aware of any empirical evidence that the widespread movement to adopt compliance programs has resulted in the institution of *effective* compliance programs" (Report at 35), but nevertheless acknowledges that the state of the art for compliance programs has advanced, and the Sentencing Commission's organizational guidelines should reflect that advance. (Executive summary at 3). We offer comments to further that goal, suggesting that the Guidelines require programs that instill ethical behavior in allegiance to standards that animate the Guidelines in addition to legal compliance with the Guidelines.

The highly publicized ethical scandals that began to crescendo in 2001 showed that companies with "paper compliance programs," but no true ethical culture, collapse quickly as unethical conduct is revealed. The scandals that led to the recent reforms, while violating the law, were reflective of a broader ethical failure that was even more troubling than the actual legal violations.

Prosecutors frequently struggled to identify the appropriate laws and charges. The positive law had not kept up with the ability of highly proficient, yet ethically untethered individuals and organizations to find loopholes. Nearly all agreed, however, that the conduct was so egregious as to breach norms of ethical behavior. A collective cry arose that "there ought to be a law."

In response, several laws, as well as regulations and new rules for self-governing organizations, such as the stock exchanges, were passed. The aim of nearly all of these was to address the shortcomings extant in the positive law; namely, its failure to address conduct that was, while unethical, not necessarily illegal. At the federal level, both the legislative and executive branches have acted to redress those shortcomings.

The animating principles and foundational precepts of the rule of law originate from shared, common values. Businesses that embrace the letter and spirit behind the law inspire and uphold a higher standard of conduct in allegiance to these shared values. This higher standard considers the consequences of actions beyond their immediate outcome to consider the ultimate impact. This higher standard also acknowledges that everything is not relative and subject to equivocation and "clever pleading"; there are fundamental truths and values that should be adopted and championed simply because they are the right thing to do.

The judiciary, through the Commission, now has the opportunity to take its proper place beside its co-branches of government in ensuring ethics plays a key role in the lawful conduct of all organizations.

The Commission has, in its proposed changes to the Guidelines, taken the bold step of recognizing the vital role organizational culture plays in establishing and maintaining an effective compliance program. In that regard, the Commission has proposed that an organization must "(1) exercise due diligence to prevent and detect violations of law; and (2) otherwise promote an *organizational culture that encourages a commitment to compliance with the law.*" (emphasis supplied).

By this statement about culture, along with its emphasis on the role of the organization's leadership, the Ad Hoc Advisory Group recognizes that the carrot and stick approach goes only so far. A compliance program is about self- governance, and an entity must use the same leadership and process management to achieve compliance that it uses to achieve any other strategic initiative. Leadership is about values, not law.

Is legal self-governance ("compliance"), possible without a commitment to ethical self-governance? That is, will a focus on legal compliance alone be sufficient?

We think not, because rules-based systems have tended to invite behavior that seeks to subvert the spirit of those rules while honoring their letter. We have seen in recent years companies attempting to "game the system" and the never-ending pursuit of loopholes and devices designed to avoid legal requirements without overtly violating them. In addition, compliance, absent an allegiance to ethics, is truly about nothing more than doing the minimum required to comply with the basic requirements. Past precedent, as discussed more fully later in this document, demonstrates that culture grounded in values and ethics has more sustainable success in establishing and maintaining higher standards of conduct than a culture that merely "encourages compliance."

The creation of an organizational culture that does what's right is not a project, but an ongoing perennial investment. Adherence to the rule of law and strict conformity with compliance obligations is necessary, but not sufficient to create such a culture. Even in areas where there is no technical violation of the law, there is a critical distinction, as Justice Potter Stewart observed, between that which one has a right to do and that which is right to do.

The emphasis on doing what is right arises from the fact that corporate reputation, as well as an individual leader's reputation, is now more at the center of public scrutiny. And it appears that businesses are increasingly recognizing that reputation is a valuable asset to be preserved, protected, and reinforced. But it is also an asset that can be damaged under the weight of negative public perception and especially judgment of ethical impropriety. Programs that address both ethics and law serve to nurture these valuable reputations by fostering cultures in which employees appreciate the gravity of their decisions and the actions they take. These well-informed decisions and actions, then observed by all who come in contact with the company--investors, customers, suppliers, consumers, etc.--garner greater trust, which may lead to preserving and, perhaps even improving, a company's reputation. The necessary condition, then, for enjoying a valuable and enduring reputation is that those who come in contact with the company believe they can trust it; but they can only trust if on a consistent basis the company does that which is right by them and others. Therein lies the centrality of reputation.

The Ad Hoc Group report also recognizes that ethics and compliance are intertwined. As the Commission notes in the proposed amendment, the "organizational culture" addition is:

> intended to reflect the emphasis on ethics and values incorporated into recent legislative and regulatory reforms, as well as the proposition that compliance with all laws is the expected behavior within organizations. (Fed. Reg. Vol.68, No. 249, 75340 at 75355 (Dec. 30, 2003)).

Discussions of ethics and its role in organizational culture permeate much of the Advisory Group's report. Indeed, the report recognizes that ethics is central to organizational culture and thus an effective compliance program. According to the report, "values-based" compliance programs already appear to be the norm among member organizations surveyed by the Ethics Officer Association (Ad Hoc Report at 52). The Ad Hoc Group also recognizes that "law compliance" is a subset of general ethical behavior. (Report at 40) "Culture," by definition, is shared values (Ad Hoc Report at 52) and, as we have pointed out above, laws are an expression of values, and legal violations are often failures of ethics.

The Defense Industry Initiative on Business Ethics and Conduct, an organization founded by 32 members of that industry, reached a similar conclusion and stated as its purpose:

> DII's essential purpose is to combine the common dedication of its Signatories to a culture and practice of ethics and right conduct in all business with the U.S. Defense Department and with others. The defense industry Signatories are united in the commitment to adopt and implement principles of business ethics and conduct that acknowledge and address their organizational responsibilities under federal procurement policy and law, thereby contributing to the National Defense. Further, they each accept the responsibility to create an organizational culture in which ethics is paramount, and compliance with federal procurement laws is a strict obligation. The DII's essential strength lies in sharing best practices to maintain the highest ethical standards, encouraging employees to ethical conduct, and requiring compliance in the course of its business activities. The DII, while not a lobbying organization, is an advocate of its principles to the defense industry, to the Government and to the Public.

Nevertheless, the Ad Hoc Group expressly intends to limit ethical assessments by courts, prosecutors and parties, stating only that "determinations of whether a particular organization has adopted a good 'set of values'" or appropriate 'ethical standards' are 'subjects which may be very difficult, if not impossible, to evaluate in an objective, consistent manner." (Report at 55).

This conclusion wrongly supposes, we believe, that the courts may lack the judgment found in self-regulating bodies and other branches of the government. Neither Congress, in The Sarbanes-Oxley Act, nor the SEC in approving the listing standards of the NYSE and Nasdaq shied away from the concept of ethics. Under those laws, and many others that we discuss below, courts will and have grappled with these subjects.

While ethics can seem to be an abstraction that calls for relative, somewhat subjective value judgments, there is actually a far more grounded, practical definition. Ethics is, simply, the shared values and norms that define how people interact. Principally, ethics is how people treat each other. Very often, ethics is explicitly expressed as positive law; at all times, ethics informs the positive law. They are inexorably intertwined.

Our concern with the proposed language and its underlying rationale, therefore, is that it both "sells the courts short" and does not comport with these more recent statutes and regulations. As a result, it could lead to *inconsistent enforcement* of both the letter and spirit of those laws.

Consequently, we believe the current environment presents a singular opportunity to establish a general requirement for *promoting a culture of ethics and compliance*, as opposed to merely a culture of compliance. We believe this is not only an achievable goal, but moreover sends a strong signal that compliance with legal minimums will not be the standard by which the sentencing courts will evaluate behavior, but instead virtue and values do indeed matter. Only through reference to fundamental legal *and ethical* principles will the Commission be able to properly discourage actions that while technically legal, undermine the spirit of the law.

Indeed, the criteria currently proposed by the Commission to determine whether an organization has promoted a culture of compliance with the law may just as easily be used to assess whether the organization has promoted a culture of compliance with law *and ethics*. Courts and prosecutors may then use the standards currently espoused in the proposed amendments for promoting a culture of compliance to just as easily measure an organization's commitment to promoting a culture of ethics and compliance. This allows for an analysis of how well the organization promotes ethics without requiring an analysis of how ethical an organization is.

Without a commitment to ethics, the Commission runs the risk of its guidelines fostering the same types of corporate cultures that allowed individuals to seek out "loopholes" in the law that led to many of the recent corporate crises. By including ethics in §8B2.1.(a)(2), the Commission not only retains intellectual consistency, but it will be implementing both the words and spirit of recent legislation and regulations.

## THE PRECEDENT FOR ETHICS

The notion of at least some government oversight of business ethics is a well-established one. And contrary to the Advisory Group's assertion, courts and prosecutors are both equipped and willing to engage in at least some assessment of ethical behavior. Indeed, much of the criminal law and the analysis of criminal behavior in the courtroom relies on an assessment of a defendant's motive. Every day, courts and juries examine motive, comparing it against the community's values *(i.e.*, its ethical framework) to determine how well or mal-intentioned the defendant's actions were. This values-based (or ethics-based) determination informs the culpability decision and ultimately, the sentence meted out. Moreover, the basic tenets of tort law are based on ethics. Before the advent of standards of strict liability, which effectively compensate harm based on notions of causation and, ultimately, who can afford to pay the compensation, tort law had as its foundation the precept of duty. Duty is simply the assigned

moral obligation to behave in a certain way--an obligation interpreted and assigned by judges and which ultimately established the common law of torts.

There is also a long history of all three branches of government encouraging, if not explicitly mandating, at least some focus on ethics in business. Indeed, among Congress's objectives in passing the federal securities laws in the early 1930s was the promotion of honest securities markets. By passing these laws, Congress sought "'to substitute a philosophy of full disclosure for the philosophy of caveat emptor and thus to achieve a high standard of business ethics in the securities industry.'" *Affiliated Ute Citizens of Utah v. United States*, 406 U.S. 128, 151, 92 S.Ct. 1456, 31 L.Ed.2d 741 (1972) (footnote omitted). And since their passage, the courts have broadly construed the securities laws over the years to achieve this stated purpose. *See Davenport v. A.C. Davenport & Son Co.*, 903 F.2d 1139, C.A.7 (Ill.),1990 ("The fundamental purpose of section 10(b) and rule 10(b)(5) is to achieve a high standard of business ethics. This purpose is taken seriously and is broadly construed").

Of course, ethics is not limited to the securities laws. Many federal laws are founded on ethical principles and require at least some recognition of those principles in applying the laws to the facts of any particular case. *See, e.g., Vulcan Engineering Co., Inc. v. Fata Aluminium, Inc.*, 278 F.3d 1366 Fed Cir. C.A.Fed. (Mich.),2002, Feb. 5, 2002. ("The rules of patent infringement are rules of *business ethics*, and require prudent commercial actions in accordance with law")(emphasis added).

And in government procurement, by both statute and regulation, the executive branch is required to assess an organization's ethics on a regular basis. Pursuant to both the Office of Federal Procurement Policy Act of 1974 and the Federal Acquisition Regulation (FAR), some of the factors to be considered in determining whether a prospective contractor is a "responsible source" include whether it has adequate financial resources; the ability to comply with delivery and performance schedule; a satisfactory performance record; and a satisfactory record of *integrity and business ethics*. 41 U.S.C. § 403(7)(Supp.2001); 48 C.F.R. § 9.104-1(a)-(d). 1

Even the common law is rife with examples of ethics finding their way into the legal analysis. One example is the tort of interference with contract. *See* RESTATEMENT (SECOND) OF TORTS § 767 cmt. i (1977) (stating that, when the courts have yet to approve or disapprove of a certain practice, "[r]ecognized standards of *business ethics* and business customs and practices are pertinent" in determining whether interference with a contract was improper) (emphasis supplied). *See also, Saglioccolo v. Eagle Ins. Co.*, 112 F.3d 226, (6th Cir. 1997) (citing the Restatement with approval); *Morrow v. FBS Ins. Montana-Hoiness Labar, Inc.*, 749 P.2d 1073, 1076 (Mont.1988) (Montana Supreme Court cited approvingly to the Restatement (Second) of Torts, § 767 at 38-39 (1977), as a correct statement of the law in Montana on proper or improper motive.); *Ackerson v. Ackerson*, 895 F.2d 1416 (Table) C.A.9 (Mont.),1990 (unpublished opinion) (noting that the Restatement in Comment 1 concludes that "when there is room for different views, the determination of whether the interference is improper or not is ordinarily left to the jury, to obtain its common feel for the state of community mores and for the manner in which they would operate upon the facts in question").

Another example is the tort of economic duress. The tort finds its basis in business ethics. "The rationale underlying the principle of economic duress is the imposition of certain minimal standards of *business ethics* in the market place." *Centric Corp. v. Morrison-Knudsen Co.*, 731 P.2d 411, 413 (Okla.1986).

Moreover, as the Advisory Group and Commission recognized, Congress and regulators have been even more than willing to prescribe at least some focus on ethics within organizations. For example, codes of ethics for senior executives of publicly traded companies are now essentially mandated by law and regulation 2, and Nasdaq and NYSE-listed companies must have codes of ethics for all employees.

In addition, the Department of Health and Human Services Office of Inspector General requires pharmaceutical manufacturers have written policies and procedures and recommends that they "develop a general corporate statement of ethical and compliance principles that will guide company operations." According to the OIG, the purpose of such a code is to "function in the same fashion as a constitution, *i.e.*, as a document that details the fundamental principles, values, and framework for action within an organization." *OIG Compliance Program Guidance for Pharmaceutical Manufacturers*, Office of Inspector General, Department of Health and Human Services, Fed. Reg. Vol. 68, No. 86, 23731 at 23733 (May 5, 2003).

And lately, responding to the sense of frustration felt by the public, even the courts have willingly entered the ethics debate, indicating a fundamental shift in the manner in which they view ethics as part of the judicial process. This has manifested itself in several ways. First, as a greater emphasis on ethics in analysis:

"The facts involved in this case reflect an inexplicable lack of *business ethics and an atmosphere of general lawlessness* that infected the very heart of one of America's leading corporate citizens." *U.S. v. Andreas*, 216 F.3d 645, (7th Cir. 2000) (referring to agricultural conglomerate Archer Daniels Midland Co.) (emphasis added).

"Rejecting [defendant's] assertions, the SEC viewed his felonious conduct as a serious breach of his obligation to maintain high standards of business ethics, a threat to the integrity of the securities market, and undermining federal taxing power...We find no basis to set aside the SEC's findings and conclusions, and therefore affirm." *Haberman v. S.E.C*, 205 F.3d 1345 (8th Cir. 2000) (unpublished disposition).

This is not to say that there should be no limitations on the courts' ability to assess ethical standards and conduct. The point of judicial analysis of an organization's commitment to ethics and law should be to assess whether the organization has effectively promoted them and not whether they have achieved some standardized culture of ethical and legal compliance. That is, courts should not assess *how ethical* an organization is, but *how hard* it has tried.

Moreover, we believe that there is little risk that a court would choose to engage in the exercise of assessing an organization's ethics. This is especially so when the principles applicable at law (*i.e.*, the Chapter 8 guidelines) provide ample guidance toward the appropriate analysis: whether

the organization has effectively *promoted* a culture of ethics and compliance. Indeed, as recently as last October, Judge Pollack declined to engage in the exercise of assessing an organization's ethical behavior, stating that "[t]he plaintiffs in the above-captioned putative class actions would have this Court punish breaches of business ethics by principles applicable at law which did not at the time apply to such conduct." However, the implication is that, had such "principles applicable at law" applied at the time, Judge Pollack would have engaged in the appropriate analysis. *In re Merrill Lynch & Co., Inc. Research Reports Securities Litigation,* 289 F.Supp.2d 416, 418 (SDNY. 2003).

And perhaps most remarkable to date has been the recent landmark settlement response – with the enforceability of the court's permanent injunction – to one of the largest securities frauds ever to occur in the United States. In *SEC v. Worldcom*, Judge Rakoff noted:

In the instant lawsuit, however, the Securities and Exchange Commission (the "Commission"), with the full cooperation of the company's new management and significant encouragement from the Court-appointed Corporate Monitor (Richard C. Breeden, Esq.), has sought something different:
-- not just to clean house but to put the company on a new and positive footing;
-- not just to enjoin future violations but to create models of corporate governance and internal compliance for this and other companies to follow;
-- not just to impose penalties but to help stabilize and reorganize the company and thereby help preserve more than 50,000 jobs and obtain some modest, if inadequate, recompense for those shareholder victims who would otherwise recover nothing whatever from the company itself.

The permanent injunction also requires the company to provide a large segment of its employees with specialized training in accounting principles, public reporting obligations, and *business ethics*, in accordance with programs being specially developed for the company by New York University and the University of Virginia. At the behest of the Corporate Monitor, the Court also obtained from the new Chief Executive Officer a sworn "*Ethics Pledge*," requiring, on pain of dismissal, a degree of transparency well beyond S.E.C. requirements. The company has since required its senior management to sign a similar pledge, and has plans to obtain similar pledges from virtually all employees.

*S.E.C. v. Worldcom, Inc.*, 273 F.Supp.2d 431, S.D.N.Y.,2003 (emphasis added).

In sum it is our considered opinion that as long as the guidelines focus on compliance and do not explicitly include an ethical component, the discussion will remain about that which is required to do and not that which is right to do. A more prudent course, and one more consistent with the activities of the other branches of government and of industry itself, is to foster a culture based on both compliance and ethics. Only in that way will we help build a system in which both compliance and virtue are their own rewards.

Consequently, we believe the Commission should make the following changes to the proposed amendments:

§8B2.1(a)(2)
"otherwise promote an organizational culture that encourages a commitment to ethics and the law."

§8B2.1(b)
"Due diligence and the promotion of an organizational culture that encourages a commitment to ethics and compliance with the law."

§8B2.1(b)(1)
"The organization shall establish ethics and compliance standards and procedures to prevent and detect violations of law."

LRN would like to again thank the Commission for this opportunity. We hope that our comments will help inform the Commission's considerations and would welcome an opportunity to testify before the Commission to further amplify our perspective.

Sincerely,

Dov Seidman
Chairman and Chief Executive Officer

[1] We also note that most government employees at the local, state, and national level are subject to various ethics requirements, including statutory ethical duties found in ethics-in-government legislation.

[2] The Securities and Exchange Commission requires that companies have and disclose codes of ethics for certain senior executives or disclose why they do not have such codes.

WRITTEN TESTIMONY OF DOV SEIDMAN,
CHAIRMAN AND CHIEF EXECUTIVE OFFICER
LRN

Let me begin my testimony by thanking the members of the Sentencing Commission and staff for giving me this opportunity. And let me also commend the Ad Hoc Advisory Group on the Organizational Sentencing Guidelines for its insightful report and recommendations. We further commend the Commission for addressing in the proposed amendments the important issues raised by the Advisory Group.

We are in troubling times for the business community, and your work is greatly appreciated by it. Trust of American business is at an exceedingly low level, perhaps the lowest since the Great Depression. The actions of a few, spectacular malfeasants have sullied the reputation of business as a whole and exposed the need for greater vigilance, and greater penalties for failures of compliance and ethics.

As the Commission has recognized, though, simply creating penalties for those who do wrong is not enough. We must provide incentives for companies to do the right thing, and encourage their employees to do the right thing, even when it may not be the easy thing.

The proposed changes to the Organizational Sentencing Guidelines are a positive continuation of the work the Commission has done in the past to further compliance, and the Commission is to be commended for that work.

However, I believe the Commission would have a greater impact on organizational behavior if it added the requirement that organizations promote an internal culture that encourages a commitment to both the law, as it has in the past, and to ethics.

I make this statement based on over ten years working with hundreds of organizations, both large and small, on legal, compliance, and ethics issues. During this time, I and my colleagues at LRN have gained a better understanding of the relationship between ethics and compliance, and more broadly, the relationship between corporate cultures and compliance. We have also gained great insight into how organizations best communicate not only the legal and regulatory requirements of their business, but also respect for the law more broadly, as well as their values and standards. And we have had the opportunity to witness and participate in what we believe could well turn out to be a sea change in the approach to addressing these critical issues.

We are observing an emerging best practice in the development of effective compliance programs. In particular, we are observing that in communicating their values and providing employees with the knowledge and information they need to succeed and thrive, they are emphasizing both ethics and legal compliance. Indeed, attention to ethics within organizations now takes many forms, from bringing to life codes of conduct through education and other means by which they are woven into the very fabric of the organization, to structuring education curricula in which law and the ethics are taught together. Or, put another way, they are designed

to remind employees of what Justice Potter Stewart taught us: that there is a difference between that which you have a right to do and that which is right to do.

The goal of such programs is to not only comply with the law, but to instill in the organization's members an atmosphere of trust, a sense of mutual respect and benefit, and a commitment to doing the right thing, not simply the required thing.

If we look to the highly publicized ethical scandals that began to crescendo in 2001, we see that companies with "paper compliance programs," but no true ethical culture, collapse quickly as unethical conduct is revealed. The scandals that led to the recent reforms, while violating the law, were reflective of a broader ethical failure that was even more troubling than the actual legal violations.

Prosecutors frequently struggled to identify the appropriate laws and charges. The positive law had not kept up with the ability of highly proficient, yet ethically untethered individuals and organizations to find loopholes. Nearly all agreed, however, that the conduct was so egregious as to breach norms of ethical behavior. A collective cry arose that "there ought to be a law." That cry helped lead us to this hearing room today.

The aim of nearly all of the laws adopted in the wake of these scandals was to address the shortcomings extant in the positive law; namely, its failure to address conduct that was, while unethical, not necessarily illegal. At the federal level, both the legislative and executive branches have acted to redress those shortcomings.

This is consistent with past law, since the animating principles and foundational precepts of the rule of law originate from shared, common values. Businesses that embrace the letter and spirit behind the law inspire and uphold a higher standard of conduct in allegiance to these shared values. This higher standard considers the consequences of actions beyond their immediate outcome to consider the ultimate impact. This higher standard also acknowledges that everything is not relative and subject to equivocation and "clever pleading"; there are fundamental truths and values that should be adopted and championed simply because they are the right thing to do.

The judiciary, through the Commission, now has the opportunity to take its proper place beside its co-branches of government in ensuring ethics plays a key role in the lawful conduct of all organizations.

The Commission has, in its proposed changes to the Guidelines, taken the bold step of recognizing the vital role organizational culture plays in establishing and maintaining an effective compliance program. In that regard, the Commission has proposed that an organization must "(1) exercise due diligence to prevent and detect violations of law; and (2) otherwise promote an *organizational culture that encourages a commitment to compliance with the law*." (emphasis supplied).

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so far. A compliance program is about self- governance, and an entity must use the same leadership and process management to achieve compliance that it uses to achieve any other strategic initiative. Leadership is about values, not law.

Is legal self-governance ("compliance"), possible without a commitment to ethical self-governance? That is, will a focus on legal compliance alone be sufficient?

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The emphasis on doing what is right arises from the fact that corporate reputation, as well as an individual leader's reputation, is now more at the center of public scrutiny. And it appears that businesses are increasingly recognizing that reputation is a valuable asset to be preserved, protected, and reinforced. But it is also an asset that can be damaged under the weight of negative public perception and especially judgment of ethical impropriety. Programs that address both ethics and law serve to nurture these valuable reputations by fostering cultures in which employees appreciate the gravity of their decisions and the actions they take. These well-informed decisions and actions, then observed by all who come in contact with the company--investors, customers, suppliers, consumers, etc.--garner greater trust, which may lead to preserving and, perhaps even improving, a company's reputation. The necessary condition, then, for enjoying a valuable and enduring reputation is that those who come in contact with the company believe they can trust it; but they can only trust if on a consistent basis the company does that which is right by them and others. Therein lies the centrality of reputation.

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Even the common law is rife with examples of ethics finding their way into the legal analysis. One example is the tort of interference with contract stating that, when the courts have yet to