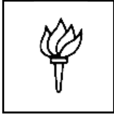

PROGRAM ON CORPORATE COMPLIANCE AND ENFORCEMENT
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To: U.S. Sentencing Commission

Re: Proposal to Reform the Mitigation Provisions of the Organizational Sentencing Guidelines and the Definition of Effective Compliance

From: Jennifer Arlen, Norma Z. Paige Professor of Law, NYU School of Law
Director, NYU Program on Corporate Compliance and Enforcement

1. Statement of the Issue and Its Importance

In their current form, the Organizational Sentencing Guidelines fail to achieve two goals that are essential to efforts to deter corporate crime: (1) they do not provide adequate incentives to induce large firms to self-report and (2) they do not provide either adequate incentives to adopt an effective compliance program or adequate guidance on the requirements for effective compliance. Reforming the mitigation provisions of the Organizational Sentencing Guidelines to provide for a greater benefit to firms that self-report, and aggravated penalties to firms that detected wrongdoing but did not self-report, could significantly improve the deterrent effect of criminal penalties for white collar crime. Effective deterrence also requires reforming the mitigation provisions of the Organizational Guidelines to increase mitigation for effective compliance, and amending the guidelines governing effective compliance.

While reform of the Organizational Guidelines is not explicitly listed as a "tentative priority" in the Proposed Priorities for the amendment cycle ending May 1, 2015, reform of the Organizational Guidelines to induce firms to self-report and adopt effective compliance programs is essential to the Commission's ability to serve Priority #2, which is the effective reform of the provisions governing economic crimes. One issue raised by at the Commission's conference last fall on economic crimes is the possibility of shortening the prison term for large economic crimes. These crimes often are committed by people working for large firms, however, who often are able to avoid detection and sanction because individual responsibility is difficult to assign within large organizations. Indeed, for this reason, there are a significant number of corporate convictions and DPAs for economic crimes where no individual was convicted, as Judge Jed Rakoff observed in his article. A traditional solution is to respond to this low threat of sanction with large penalties. A superior approach, however, is reasonable penalties coupled with a higher probability of sanction. The Commission can best achieve this goal—and reform individual liability while publicly affirming its commitment to deterring economic crime—by reforming the Organizational Guidelines to ensure that firms that self-report benefit substantially, firms that detect but do not self-report bear enhanced penalties, and that all firms adopted effective, concrete and measurable compliance programs.

2. Reforming the Mitigation Provisions of the Organizational Sentencing Guidelines Should Be a Priority for the Sentencing Commission

Over the last few years, we have witnessed the devastating effects on both the U.S. economy and individual victims of pervasive corporate crime. At the same time, we have seen a depletion of government resources resulting in government furloughs and shut downs, which have drastically impacted the ability to investigate and prosecute these protracted and costly litigations. The Sentencing Commission must make reforming the mitigation provisions of the Organizational Sentencing Guidelines a priority so that we can deter corporate crime and conserve enforcement resources by inducing firms to adopt truly effective compliance programs that deter wrongdoing and to provide vital cooperation through corporate self-reporting of any crimes that do occur.

The central areas in need of particular attention are:

1. The guidelines governing what constitutes "Effective Compliance"
2. The provisions governing mitigation for Self-Reporting
3. The provisions governing mitigation for Effective Compliance
4. The provisions governing mitigation for Acceptance of Responsibility
5. The guidelines governing the circumstances under which probation should be used to impose a compliance mandate and the guidelines governing the type of compliance mandates that should be imposed.

a. Need for and Goals of Reform

Both the strength of the U.S. economy and the well-being of our citizens depend, in part, on our ability to deter corporate crime, especially by large corporations. Federal authorities cannot effectively deter crime unless they can ensure that crime does not pay by making sure that employees (including managers) who commit crimes face expected penalties that exceed the benefit they get from committing the crime. This simple goal is not easy to achieve, however. In the case of large firms, the government often cannot cost-effectively detect wrongdoing on its own. In order to deter corporate crime by large firms, corporate sanctions must be structured to induce large corporations to help federal prosecutors detect and punish corporate crime. Specifically, firms must be encouraged to detect and report wrongdoing, and to cooperate with the government's effort to identify and sanction the individuals responsible for the crime. Firms can do this by (1) adopting compliance programs *ex ante* that detect crime, and (2) intervening *ex post* to investigate and report suspected wrongs and fully cooperate with the government's effort to identify and sanction the individual responsible for the crime. These measures, hereinafter referred to as "self-policing," help deter crime by increasing the probability that individual wrongdoers are criminally sanctioned if they violate the law.

Firms will not engage in self-policing unless they face substantially lower expected sanctions if they detect and self-report wrongdoing, and cooperate than if they do not. The Organizational Sentencing Guidelines took an important first step towards achieving these goals by formally recognizing that firms should receive substantial mitigation if they help deter and report wrongdoing. See U.S.S.G § 8C2.5(g)(1). Yet the mitigation provisions will only achieve their goals if firms get sufficient mitigation that they are better off if they self-

report and get mitigation, or have effective compliance and receive mitigation, than if they do not undertake self-policing.

The existing Organizational Sentencing Guidelines unambiguously do not grant sufficient mitigation to large firms to make it worth their while to either adopt an effective compliance program or self-report. The problem is that the Organizational Sentencing Guidelines grant dramatically less mitigation to large firms that self-report, have effective compliance, and cooperate than afforded similarly situated small firms. Indeed, the Guidelines' mitigation provisions are particularly inadequate in the very circumstances where corporate detection and investigation is most important: in cases involving crimes committed by managers of large firms. As a result, U.S. efforts to deter corporate crime are undermined by strict adherence to the Organizational Sentencing Guidelines. This may partly explain why the Department of Justice has increasingly employed DPAs and NPAs with organizational defendants, effectively adopting an alternative strategy for encouraging corporate reporting and cooperation, which differs materially from the Organizational Guidelines.

To illustrate the problem, it is helpful to ask when a firm will self-report. A firm will self-report, thereby guaranteeing a sanction, if the sanction it pays following its self-reports is substantially less than the *expected* corporate penalty the firm faces if it does not, which is given by the penalty imposed on firms that do not self-report (F) multiplied by the probability that the crime will be detected if the firm does not self-report (P): PF. Thus, if the government is 50% likely to detect a crime without self-reporting then a firm that self-reports should face a sanction that is less than half as large as those that do not. The Organizational Guidelines currently do not provide sufficient mitigation for large firms to self-report crimes that the government is not highly likely to detect on its own.

To see this, all one needs to do is to examine Table One, which shows the percentage mitigation granted to firms that obtain 5 points of mitigation for self-reporting, cooperating and accepting responsibility, based on the firm's initial unmitigated culpability score.

Table One
Effect of Self-Reporting, Cooperating and Accepting Responsibility (5 pt)

Unmitigated Culpability Score USSG § 8C2.5	Unmitigated Multiplier (Min-Max) USSG §8C2.6	Mitigated Culpability Score (5 pt) USSG § 8C2.5(g)(1)	Mitigated Minimum Multiplier USSG §8C2.6	Mitigated Maximum Multiplier USSG §8C2.6	Percentage Reduction Minimum Multiplier	Percentage Reduction Maximum Multiplier
14	2.00–4.00	9	1.80	3.60	10%	10%
13	2.00–4.00	8	1.60	3.20	20%	20%
12	2.00–4.00	7	1.40	2.80	30%	30%
11	2.00–4.00	6	1.20	2.40	40%	40%
10	2.00–4.00	5	1.00	2.00	50%	50%
9	1.80–3.60	4	0.80	1.60	56%	56%
8	1.60–3.20	3	0.60	1.20	63%	63%
7	1.40–2.80	2	0.40	0.80	71%	71%
6	1.20–2.40	1	0.20	0.40	83%	83%
5	1.00–2.00	0	0.05	0.20	95%	90%
4	0.80–1.60	-1	0.05	0.20	94%	88%
3	0.60–1.20	-2	0.05	0.20	92%	83%
2	0.40–0.80	-3	0.05	0.20	88%	75%
1	0.20–0.40	-4	0.05	0.20	75%	50%
0	0.05–0.20	-5	0.05	0.20	0%	0%

Examining Table One, we see that small firms (with culpability scores of 5) can get 90% mitigation for self-reporting, accepting responsibility and cooperation. By contrast, a large firm convicted of a crime involving managers, starts with an unmitigated culpability score of 10 or higher. The maximum mitigation for such a firm is 50%, which is sufficient to induce self-reporting only if the government is very likely to detect the wrong on its own (50% likely, to be precise). If it has any past wrongdoing, if may get as little as 30%. Thus, unless the government is 50% likely to detect the crime, the firm will not self-report.

Moreover, closer examination of the Organizational Guidelines, demonstrates that Table One overstates the benefit to firms of self-reporting. It is true that a firm that self-reports, cooperates and accepts responsibility gets 5 points of mitigation. But firms can still receive 2 of those mitigation points without self-reporting. This means that the benefit to a firm of self-reporting, over and above cooperation, is only 3 points.

Examining Table Two, we see that, once we recognize that firms can get 2 out of the 5 points simply by cooperating (if the wrong is independently detected), then the mitigation provisions of the Organizational Guidelines provide little incentive to self-report to any firm which starts with an unmitigated culpability score over 5. This means that larger firms generally get little credit for reporting crimes such as fraud.

Table Two
Marginal Benefit of Self-Reporting (3 pt)

Culpability Score	Unmitigated Multiplier (Min-Max)	Mitigated Culpability Score	Mitigated Minimum Multiplier	Mitigated Maximum Multiplier	Reduction Minimum Multiplier	Reduction Maximum Multiplier
14	2.00–4.00	11	2.00	4.00	0%	0%
13	2.00–4.00	10	2.00	4.00	0%	0%
12	2.00–4.00	9	1.80	3.60	10%	10%
11	2.00–4.00	8	1.60	3.20	20%	20%
10	2.00–4.00	7	1.40	2.80	30%	30%
9	1.80–3.60	6	1.20	2.40	33%	33%
8	1.60–3.20	5	1.00	2.00	38%	38%
7	1.40–2.80	4	0.80	1.60	43%	43%
6	1.20–2.40	3	0.60	1.20	50%	50%
5	1.00–2.00	2	0.40	0.80	60%	60%
4	0.80–1.60	1	0.20	0.40	75%	75%
3	0.60–1.20	0	0.05	0.20	92%	83%
2	0.40–0.80	-1	0.05	0.20	88%	75%
1	0.20–0.40	-2	0.05	0.20	75%	50%
0	0.05–0.20	-3	0.05	0.20	0%	0%

Firms with more than 200 employees can expect to have a culpability score of at least 8 for most crimes, such as health care fraud, securities fraud, and false claims, that tend to involve the participation of either high-level personnel of the unit (or the firm) or multiple supervisory personnel. See U.S.S.G. § 8C2.5(b)(3). This implies that firms with 200 or more employees regularly start with an unmitigated culpability score of at least 8. None of these firms can obtain even a 40% reduction in their fine if they report. Thus, as long as the government has less than a 60% chance of detecting the crime on its own, these firms fare better if they do not report. Indeed, we see that the Guidelines deter self-reporting when it is most needed—when the government would be unlikely to detect the crime on its own but could obtain the evidence needed to sanction wrongdoers if the firm self-policies and self-reports..

Indeed, even these numbers over-state the credit given for mitigation. The reason is that the mitigation provisions only apply to the fine. But most firms whose employees

commit an economic crime also must pay restitution as well. This means that the multiplier for a firm with an unmitigated culpability score of 10 gives rise to a sanction that is likely to be 3-5 times the base fine, and not 2-4 times. Given this, we see that the benefit of self-reporting, cooperating, and accepting responsibility is far less than it first appeared, because these activities reduce the criminal fine but do not necessarily affect criminal restitution or remediation penalties. Accordingly, if we look at the effect of self-reporting, cooperating, and accepting responsibility on the total expected criminal penalty, we see that firms rarely can expect as much as a 50% reduction in their expected criminal penalty if remediation/restitution payments only equal the base fine. Again, the problem is pronounced for firms whose unmitigated culpability score exceeds 6—which is to say firms (with greater than 200 employees) whose managers were complicit in the crime. Such firms would be better off not self-reporting detected crimes if they expect to fall under the Guidelines and if there is less than a 50% chance that the government will detect the wrong if the firm does not report it.[1]

In addition, the Organizational Guidelines give firms that did not self-detect the wrong (and thus did not self-report it) far too little incentive to cooperate and accept responsibility. The problem, once again, is particularly severe in the case of large firms. Firms that cooperate and accept responsibility, in effect, end up guaranteeing their own conviction most of the time. Yet the Sentencing Commission structured the Guidelines so that a large firm with at least 5,000 employees (and complicit higher-level personnel) receives only a 20% reduction in its expected fine in return for its cooperation if they did not self-report the wrong, even if the firm's cooperation enables the government to obtain convictions (of the firm and the responsible individuals) that it likely could not otherwise obtain. See U.S.S.G. § 8C2.5(g)(2).

Table Three
Effect of Cooperating and Accepting Responsibility (2 pt

Culpability Score	Unmitigated Multiplier (Min-Max)	Mitigated Culpability Score	Mitigated Minimum Multiplier	Mitigated Maximum Multiplier	Reduction Minimum Multiplier	Reduction Maximum Multiplier
14	2.00–4.00	12	2.00	4.00	0%	0%
13	2.00–4.00	11	2.00	4.00	0%	0%
12	2.00–4.00	10	2.00	4.00	0%	0%
11	2.00–4.00	9	1.80	3.60	10%	10%
10	2.00–4.00	8	1.60	3.20	20%	20%
9	1.80–3.60	7	1.40	2.80	22%	22%
8	1.60–3.20	6	1.20	2.40	25%	25%
7	1.40–2.80	5	1.00	2.00	29%	29%
6	1.20–2.40	4	0.80	1.60	33%	33%
5	1.00–2.00	3	0.60	1.20	40%	40%
4	0.80–1.60	2	0.40	0.80	50%	50%
3	0.60–1.20	1	0.20	0.40	67%	67%
2	0.40–0.80	0	0.05	0.20	88%	75%
1	0.20–0.40	-1	0.05	0.20	75%	50%
0	0.05–0.20	-2	0.05	0.20	0%	0%

[1] See Jennifer Arlen, *The Failure of the Organizational Sentencing Guidelines*, 66 UNIV. OF MIAMI L. REV. 321 (2012) (Symposium Issue).

To see this, consider Table Three. A firm with at least 1,000 employees only receives a 22% reduction in its expected fine for cooperation (if it did not self-report). This is reasonable if corporate cooperation has little effect on the government's ability to sanction the firm and the responsible individuals. Yet often this is not the case. Indeed, the DOJ has concluded that in many cases (especially those involving large firms) corporate cooperation is vitally important to detection and prosecution in the first instance. If this cooperation increases the probability of sanction by even 25%, firms subject to the Guidelines can be expected to be loath to provide it.

b. Evidence that the Organizational Guidelines Do Not Achieve their Goals

The conclusion that the Organizational Guidelines do not provide firms with adequate incentives to adopt effective compliance programs, self-report, and fully cooperate is supported by evidence that following the adoption of the Organizational Guidelines (and prior to the use of DPAs and NPAs) few publicly held firms self-reported. In addition, the duration of corporate crimes by publicly-held firms was the same after the adopting of the Guidelines as before (Cindy R. Alexander, Jennifer Arlen & Mark A. Cohen, *Regulating Corporate Criminal Sanctions: Federal Guidelines and the Sentencing of Public Firms,* 42 J. L. & ECON. 393 (1999)). This is consistent with the hypothesis that the Guidelines had little effect on detection and reporting.

More recently, analysis of the Sentencing Commission's data on corporate criminal convictions found that few firms convicted of wrongdoing self-reported the crime. See Jennifer Arlen, *Economic Analysis of Corporate Criminal Liability: Theory and Evidence, in* RESEARCH HANDBOOK ON CRIMINAL LAW (Keith Hylton & Alon Harel, ed., 2012). This may be explained in part by the fact that firms that self-report often are subject to deferred and non-prosecution agreements instead of criminal pleas. Yet hundreds of firms are convicted. The relative dearth of self-reporting and effective compliance suggests that the Organizational Guidelines are not achieving one of their central goals.Additional evidence that the incentives to self-report and adopt effective compliance are not high enough can be found by looking that the Department of Justice's DPAs and NPAs. Some firms with DPAs or NPAs did self-report. But most did not—even though some did assisting the government in obtaining evidence of the wrong. Moreover, many, if not most, firms did not adopt an effective compliance programs. This could simply mean that prosecutors assume compliance is ineffective when a crime occurs. But an examination of select cases reveals that prosecutors tend to be correct: compliance is ineffective. This suggests that existing incentives and guidance are not strong enough.

Additional evidence that reform is needed can be found in the sanctions set forth in the Department of Justice's DPAs and NPAs. If the Organizational Guidelines provide adequate mitigation, one would expect the DOJ to adhere to the Organizational Guidelines when sanctioning firms that self-report and cooperate, even when the sanction is imposed through a DPA or NPA. The Guidelines ideally would state a level of mitigation that the DOJ deems to be appropriate. Yet when we look at the DPAs, we see that the DOJ almost always grants substantial downwards mitigation for self-reporting, indicating that it cannot achieve its goals if it adheres to the Organizational Guidelines when sanctioning large firms.

3. Reform of the Provisions Governing Effective Compliance also Should be a Priority

When they were originally adopted, the Organizational Guidelines were truly groundbreaking in recognizing the importance of compliance and trying to provide guidance to prosecutors and firms on the nature of optimal compliance.

The U.S. Sentencing Commission could dramatically improve compliance, and help prosecutors, by revising the definition of effective compliance to bring it up to date. Two issues are of particular concern. The current provisions focus on compliance as being a matter of ethics and training. Yet empirical evidence, and recent experience reveals, that corporate compensation and promotion policies are directly implicated in inducing crime and in turn in deterring it. Effective compliance is not possible under a compensation and promotion policy that puts employees in fear for their jobs if they don't "hit their numbers" even in a down market. An examination of many large crimes reveals the role of compensation in encouraging the crime. See generally *Economic Analysis of Corporate Criminal Liability: Theory and Evidence, in* RESEARCH HANDBOOK ON CRIMINAL LAW (Keith Hylton & Alon Harel, ed., 2012) (discussing the evidence).

Some federal prosecutors have recognized this. An examination of the Siemens guilty plea shows an effort to incorporate compliance into performance reviews and bonuses. The Commission could greatly benefit prosecutors and firms by stating that compensation and promotion policies should be considered part of compliance. The DOJ has already done this with the guidelines it issues under the FCPA guidance. It would be beneficial for the Organizational Guidelines also to consider compensation and promotion.

2. Role of Outside Directors: Cases such as WalMart and GM reveal that, in the case of publicly held firms, deterrence will not be effective unless the compliance officer is a senior official who reports directly to outside members of the board. It would be useful to discuss whether to make this reporting a stronger and more frequent requirement under the Guidelines.

Examination of the compliance program mandates in DPAs reveals that the DOJ often is forced to look beyond the guidelines when fashioning an effective compliance program. Indeed, the discussion of effective compliance in the DOJ and SEC's FCPA Guidance considers important factors, such as compensation structure, that would benefit from more addition in the mitigation provisions of the Guidelines.

4. Conclusion

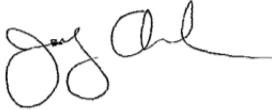
In promulgating the Organizational Sentencing Guidelines, the goals of the Sentencing Commission were to reduce and ultimately eliminate criminal conduct by providing a structural foundation from which an organization may self-police its own conduct through effective compliance, ethics programs, self-reporting and cooperation. U.S.S.G. Chapter Eight, Introductory Commentary. In order for the Organizational Guidelines to achieve these goals, the benefit to organizations that truly comply and self-report must be substantial and meaningful. Indeed, the benefit to the organization must outweigh the certainty of self-reporting and the inevitable corollary punishment. The most effective ways to achieve the Commission's goals are by reforming the mitigation provisions of the Organizational Sentencing Guidelines to provide a greater benefit to organizations that self-report and by redefining what constitutes an effective compliance program in a concrete and measurable way.

The Commission also concluded that the Organizational Guidelines should induce firms to adopt effective compliance programs. Recent experience has revealed the vital role of compensation and promotion policies and independent director oversight in achieving effective corporate compliance programs. Reform of the compliance program provisions would help the DOJ encourage firms to adopt compliance programs that are genuinely effective, concrete and measurable.

Reforming the mitigation provisions of the Organizational Sentencing Guidelines and solidifying the definition of an effective compliance program will not only support the Commission's effort to reform the provisions governing economic crimes, but would serve the Commission's goals of "provid[ing] just punishment, adequate deterrence and incentives for organizations to maintain internal mechanisms for preventing, detecting and reporting criminal conduct." United States Sentencing Guidelines Manual, Chapter Eight – Sentencing of Organizations, Introductory Commentary.

Thank you for considering this proposal.

Yours,



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