

DELIVERED BY ELECTRONIC TRANSMISSION

15 March 2004

United States Sentencing Commission  
One Columbus Circle, N.E., Suite 2-500  
Washington DC 20002-8002  
Attention: Public Affairs

Subject: Testimony/Statement of Kenneth W. Johnson, Director, Ethics & Policy Integration Centre before the United States Sentencing Commission on March 17, 2004 re: Proposed Amendments to Chapter Eight

**Introduction.** This letter is offered in response to the Commission's invitation to address the Commission.

My interest in ethics, compliance, and social responsibility programs stems from my experiences during and following the Gulf War, where I served as Logistics Plans Officer for the First Marine Expeditionary Force. After nearly a year on active duty, including leading the Marine Corps logistics team to the Central Command after-action review conference, I returned to civilian life convinced that there had to be a better way for organizations to live their values while pursuing excellence in their organizational affairs.

Upon my return to the United States, I pursued a Masters in Ethics and Policy Studies. I have consulted internationally on ethics, compliance and social responsibility programs, since 1993 with an emphasis lately on program good corporate governance in emerging market economies. I have advised a number of small enterprises in the real estate and entertainment industries in California, including the laws, rules, and regulations involving real estate, securities, franchising, and labor relations. In the 1980s, I owned and operated a real estate services firm that supported savings and loans associations in California during the S & L crisis. My ethics and policy consulting practice has involved evaluating ethics and compliance programs for the U.S. Air Force under its Voluntary Disclosure Program and work with the Maryland Mediation and Alternative Conflict Resolution Office on a national project to evaluate public policy programs.

Next month, the Department of Commerce will publish a practical guide to designing and implementing an ethics, compliance, and social responsibility program in emerging market economies: Kenneth W. Johnson and Igor Y. Abramov, *Business Ethics: A Manual For Managing A Responsible Business Enterprise In Emerging Market Economies*. I have provided staff with a more detailed biography.

On balance, the proposed changes/additions reflect well-considered application of the corporate experience over the last 12 years in designing, implementing, and

Testimony before the USSC  
17 March 2004  
Page 2

enforcing an effective program to prevent and detect violations of the law. I am confident that many provisions of the Proposed Amendments, such as those aimed at achieving a culture of commitment to compliance, assessment of the risks confronting the organization, regular program evaluation, and elaborating on the roles of the governing authority and organizational leadership will provide greater guidance to organizations and courts alike regarding the criteria for program effectiveness.

As I prepared my comments before this Commission, I intended to concentrate on three areas where the Proposed Amendments can be improved:

- (1) Program features, including more proactive roles for the governing authority and organizational leadership;
- (2) Program design process, including augmenting §8B2.1(c) to link explicitly risk assessment, expected program outcomes, and regular program evaluation; and
- (3) Small to medium enterprise considerations, including making the case for a new §8B2.1(d) giving prominent recognition to the challenges in designing and implementing ethics/compliance programs for small to medium enterprises.

Having reviewed the public responses to the Proposed Amendments, however, I now want to address these three issues from a perspective that touches on some of the concerns I saw expressed in these responses.

## **I. Scope of an Effective Program to Prevent and Detect Violations of Law**

**A. Defining the “Good Corporate Citizen.** In the PROCEEDINGS OF THE SECOND SYMPOSIUM ON CRIME AND PUNISHMENT IN THE UNITED STATES, Win Swenson, then the Commission’s Deputy General Counsel, answered a number of questions about the Federal Sentencing Guidelines for Organizations. The second question he asked and answered was, “What Were the Sentencing Commission’s Objectives in establishing the Carrot and Stick Approach?”

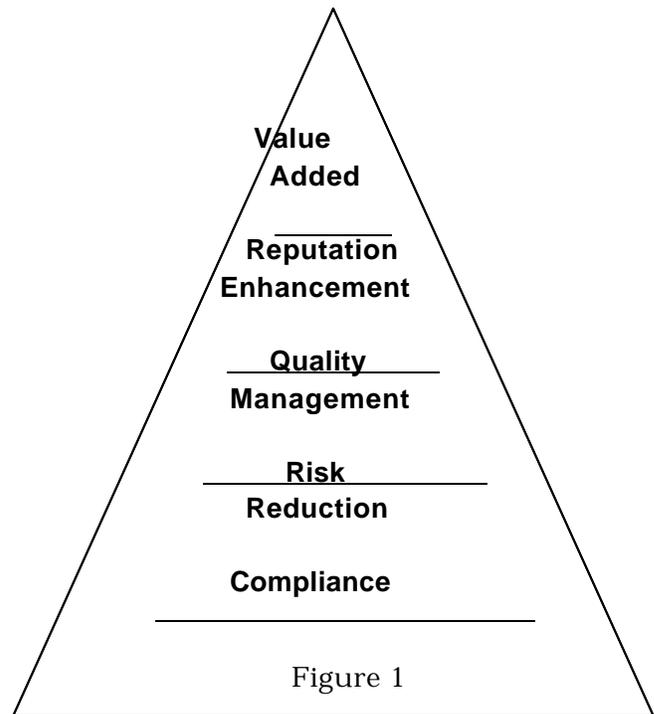
Mr. Swenson relayed that the Commission had three principal objectives in structuring the organizational guidelines as it did. Summarizing his answer, the guidelines were to (1) define a model for corporate action that would exemplify “good corporate citizenship” with respect to the narrow issue of law abidance; (2) incorporate that model into the guidelines so that penalties would depend on objective, defined criteria that would reflect a corporation’s true culpability for criminal conduct; and (3) use the model to create incentives for companies to take crime-controlling actions that satisfy its model of good corporate citizenship.

Testimony before the USSC  
17 March 2004  
Page 3

He concluded by saying that

The new policy is interactive. Companies take actions to join the fight against corporate crime and government responds by significantly limiting potential penalties for the companies that do. Limited government enforcement resources are augmented by the potentially highly effective efforts of companies themselves.

In my work with the FSGO, both domestically and as a framework for companies in emerging markets, I have taken Mr. Swenson's comments to heart. I encourage my clients to explore how to design, implement, and enforce an effective program to prevent and detect violations of law as an integral part of being a good corporate citizen. For example, I use Figure 1, opposite, to argue that management is not likely to achieve quality management or enhance the organization's reputation without dealing systemically with compliance and risk reduction.



I recognize, of course, that the charter of the Commission is restricted to sentencing for Federal crimes, but I believe the approach of the framework of seven minimum steps is holistic. By that I mean that it describes minimum steps to engage the organization as a whole to combat crime and corruption, not simply as a set of minimum practices. By this I mean that the framework of "types of steps" was intended to guide the thought processes of the governing authority and organizational leadership that would lead to an organization committed to being a good corporate citizen, not one concerned solely with complying with criminal statutes. Moreover, I cannot imagine that one can design, implement, and enforce an effective program to prevent and detect criminal conduct, where management distinguishes between complying with laws that have a criminal sanction and those that do not.

Since the current guidelines do not address the role of leadership in an effective program beyond the role of the responsible officer, the design and implementation of these programs has become, in my view, a practice of selecting among bundles of best practices that conferences and consultants urge organizations to follow. These best practices are often urged without full understanding of the

Testimony before the USSC  
17 March 2004  
Page 4

organizational culture, core beliefs, and business environment of the immediate audience or even of the organizations that developed the “best practices.” A prime example, in my view, is the dramatically different visions of the role of an ombuds office in a program to encourage employees and agents to seek advice and report misconduct. In some organizations, the ombuds is indistinguishable from an ethics officer. In others, they are advocates. In still others, they are primarily conduits.

I understand the concern of many of the commentators that the proposed language “effective program to prevent and detect violations of law,” is defined to include the non-criminal. However, I believe that such concerns confuse the Commission’s vision, even under the current guidelines, with the strictures of the “compliance program” requirements of specific criminal statutes.

For example, there are many requirements for distinct compliance programs: the expanding anti-money laundering provisions under the USA Patriot Act is but one. The FSGO, in my view, contemplate a program as an integral part of a corporate way of life. It leaves to specific criminal provisions specific compliance requirements. For example, the Foreign Corrupt Practices Act of 1977 has very specific requirements for due diligence, a system of internal accounting, and reporting,<sup>1</sup> which the FSGO’s types of steps address only generally. These were proposed by the SEC, date well before the FSGO, and have been influential internationally.

**B. Far from pushing the edge of the envelope, the Proposed Amendments are perfectly consistent with the current developments in corporate governance and internal controls.** Indeed, in my view, they do not go quite far enough to reflect Congressional and regulatory efforts since 1991 to “improve the tone at the top” of organizations, as the SEC often declares. Support for the underlying logic of the Proposed Amendments can be found in the favorable SEC reference to the definition of an “Internal Control Framework” of the Committee of Sponsoring Organizations of the Treadway Commission (“COSO”).<sup>2</sup> As the SEC described the basis for its original proposed rule on management reporting on internal controls:

*the COSO Framework defined internal control as “a process, effected by an entity’s board of directors, management and other personnel, designed to provide reasonable assurance regarding the achievement of objectives” in three categories--effectiveness and efficiency of operations; reliability of financial reporting; and compliance with applicable laws and regulations.*

---

<sup>1</sup> See Exchange Act Section 13(b)(2) [15 U.S.C. 78m(b)(2)].

<sup>2</sup> COSO, Internal Control — Integrated Framework—Executive Summary, <[http://www.coso.org/Publications/executive\\_summary\\_integrated\\_framework.htm](http://www.coso.org/Publications/executive_summary_integrated_framework.htm)>, accessed 11 March 2004.

Testimony before the USSC

17 March 2004

Page 5

COSO further stated that internal control consists of: the control environment, *risk assessment*, control activities, information and communication, and monitoring. *The scope of internal control therefore extends to policies, plans, procedures, processes, systems, activities, functions, projects, initiatives, and endeavors of all types at all levels of a company.*<sup>3</sup> (emphasis added)

To demonstrate that the Proposed Amendments—including the provisions regarding violations of laws, rules, and regulations; risk assessment;<sup>4</sup> and program evaluation—should not be seen as requiring significantly new and onerous burdens on organizations, the table that follows compares and contrasts the COSO Internal Controls framework with the “seven minimum steps” of the Proposed Amendments. In my view, they compare quite favorably:

---

<sup>3</sup> Final Rule on MANAGEMENT'S REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING AND CERTIFICATION OF DISCLOSURE IN EXCHANGE ACT PERIODIC REPORTS SECURITIES AND EXCHANGE COMMISSION, 17 CFR PARTS 210, 228, 229, 240, 249, 270 and 274 [RELEASE NOS. 33-8238; 34-47986; IC-26068; File Nos. S7-40-02; S7-06-03]

<sup>4</sup> COSO is also preparing a more comprehensive framework regarding risk assessment entitled the “Enterprise Risk Management Framework.” The draft version was subject to 90 days public comment last year. The final framework is to be published in summer, 2004.

Testimony before the USSC

17 March 2004

Page 6

| Component   | COSO Framework   | Proposed Amendments  |
|---|--|--|
| <p><b>Role of Governing Authority and organizational leadership</b></p> | <p>a process, effected by an entity's board of directors, management and other personnel</p>   | <p>Treated in §8B2.1(b)(2)</p> <ul style="list-style-type: none"> <li>• Role under proposed amendments addresses governing authority and organizational leadership, but is somewhat more passive.</li> <li>• Recommend that the role be more proactive:</li> <li>• Governing authority directing an “effective program” as a matter of policy.</li> <li>• Organizational leadership directing design, implementation, and enforcement as well as demonstrating their commitment</li> </ul> |
| <p><b>Purpose of Internal Controls</b></p>                              | <p>designed to provide reasonable assurance regarding the achievement of objectives in three categories</p> <ul style="list-style-type: none"> <li>• effectiveness and efficiency of operations;</li> <li>• reliability of financial reporting; and</li> <li>• <b>compliance with applicable laws and regulations.</b> (emphasis added)</li> </ul> | <p>§8B2.1. Effective Program to Prevent and Detect Violations of Law</p> <p>(a) [A]n organization shall—</p> <p>(1) exercise due diligence to prevent and detect violations of law;</p> <ul style="list-style-type: none"> <li>• Primary difference is definition of violation of law that includes non-criminal liability</li> </ul>  |

Testimony before the USSC

17 March 2004

Page 7

| Component                      | COSO Framework  | Proposed Amendments   |
|--------------------------------|---|---|
| <p><b>Scope of program</b></p> | <p><b>Control Environment</b></p> <p>--The control environment sets the tone of an organization, influencing the control consciousness of its people. It is the foundation for all other components of internal control, providing discipline and structure. Control environment factors include the integrity, ethical values and competence of the entity's people; management's philosophy and operating style; the way management assigns authority and responsibility, and organizes and develops its people; and the attention and direction provided by the board of directors.</p>  | <p>§8B2.1. Effective Program to Prevent and Detect Violations of Law</p> <p>(a) [A]n organization shall—</p> <p>(2) otherwise promote an organizational culture that encourages a commitment to compliance with the law.</p> <ul style="list-style-type: none"> <li>• Note the reference to integrity, ethical values, and leadership style as a matter of good business.</li> </ul>  |
| <p><b>Risk Assessment</b></p>  | <p>--Every entity faces a variety of risks from external and internal sources that must be assessed. A precondition to risk assessment is establishment of objectives, linked at different levels and internally consistent. Risk assessment is the identification and analysis of relevant risks to achievement of the objectives, forming a basis for determining how the risks should be managed. Because economic, industry, regulatory and operating conditions will continue to change, mechanisms are needed to identify and deal with the special risks associated with change.</p> | <p>§8B2.1(c) In implementing subsection (b), the organization shall conduct ongoing risk assessment and take appropriate steps to design, implement, or modify each step set forth in subsection (b) to reduce the risk of violations of law identified by the risk assessment.</p> <ul style="list-style-type: none"> <li>• Note same use of term and emphasis on importance of risk assessment to establishing objectives</li> <li>• Recommend linking risk assessment, specific program objectives, and program evaluation in subsection (c).</li> </ul> |

Testimony before the USSC

17 March 2004

Page 8

| Component                        | COSO Framework  | Proposed Amendments   |
|----------------------------------|---|---|
| <p><b>Control Activities</b></p> | <p>--Control activities are the policies and procedures that help ensure management directives are carried out. They help ensure that necessary actions are taken to address risks to achievement of the entity's objectives. Control activities occur throughout the organization, at all levels and in all functions. They include a range of activities as diverse as approvals, authorizations, verifications, reconciliations, reviews of operating performance, security of assets and segregation of duties.</p> | <p>§8B2.1(b) Due diligence and the promotion of an organizational culture that encourages a commitment to compliance with the law within the meaning of subsection (a) minimally require the following steps:</p> <ul style="list-style-type: none"> <li>• Note more specific in terms of types of steps, but less detailed in terms of processes within those steps</li> </ul> |

Testimony before the USSC

17 March 2004

Page 9

| Component                                   | COSO Framework  | Proposed Amendments   |
|---|---|---|
| <p><b>Information and Communication</b></p> | <p>--Pertinent information must be identified, captured and communicated in a form and timeframe that enable people to carry out their responsibilities. Information systems produce reports, containing operational, financial and compliance-related information, that make it possible to run and control the business. <b>They deal not only with internally generated data, but also information about external events, activities and conditions necessary to informed business decision-making and external reporting.</b> Effective communication also must occur in a broader sense, flowing down, across and up the organization. All personnel must receive a <b>clear message from top management</b> that control responsibilities must be taken seriously. They must <b>understand their own role in the internal control system, as well as how individual activities relate to the work of others.</b> They must have a <b>means of communicating significant information upstream.</b> There also needs to be effective communication with external parties, such as customers, suppliers, regulators and shareholders. (emphasis added)</p> | <ul style="list-style-type: none"> <li>• §8B2.1(b)(4): communication of standards and procedures (Recommend more emphasis on management’s commitment to compliance as a part of communications)</li> <li>• §8B2.1(b)(5): means of seeking advice and reporting concerns.</li> <li>• Issue: what is required to encourage employees and agents to seek advice and report concerns? Anonymity and/or enforceable promise of confidentiality?</li> <li>• Issue: Problem with Sarbanes-Oxley Act of 2002 language; Confidential, anonymous,” makes no sense grammatically.</li> </ul> |

Testimony before the USSC  
 17 March 2004  
 Page 10

| Component                | COSO Framework   | Proposed Amendments  |
|--------------------------|--|--|
| <p><b>Monitoring</b></p> | <p><b>--Internal control systems need to be monitored--a process that assesses the quality of the system's performance over time.</b><br/>                     This is accomplished through ongoing monitoring activities, separate evaluations or a combination of the two. Ongoing monitoring occurs in the course of operations. It includes regular management and supervisory activities, and other actions personnel take in performing their duties. The scope and frequency of separate evaluations will depend primarily on an assessment of risks and the effectiveness of ongoing monitoring procedures. <b>Internal control deficiencies should be reported upstream, with serious matters reported to top management and the board.</b><br/>                     (emphasis added)</p> | <p>The Proposed Amendment, §8B2.1(c), requiring risk assessment is a positive development. Will be more powerful if it is expanded to require that the assessment of risk be translated into specific program outcomes, and that the program be regularly evaluated to determine whether the program meets those expected program outcomes under §8B2.1(c). The provisions for auditing, monitoring, and reporting in subsection (b)(5) are internal to the program itself. They are specifically aimed at compliance and risk reduction, whereas program evaluation addresses how effective the program was at achieving specific outcomes, intended to address identified risks.</p> |

Further support for the Proposed Amendments' definition of "violation of law" can be found in the recent Final New York Stock Exchange Corporate Governance Rules, which require that a listed organization's corporate governance guidelines address, *inter alia*:

**Compliance with laws, rules and regulations (including insider trading laws.** The company should *proactively promote* compliance with *laws, rules and regulations*, including insider trading laws. Insider trading is both unethical and illegal, and should be dealt with directly.<sup>5</sup> (emphasis added)

<sup>5</sup> New York Stock Exchange, Final NYSE Corporate Governance Rules, Section 303A, "References to Form 10K, item 10 "Listed companies must adopt and disclose a code of business conduct and ethics for directors, officers and employees, and promptly disclose any waivers of the code for directors or executive officers," pp. 15-16, <<http://www.nyse.com/pdfs/finalcorpgovrules.pdf>>, accessed March 12, 2004.

Testimony before the USSC  
17 March 2004  
Page 11

Finally, rather than increasing the “burden” on company programs, the Proposed Amendments, in some ways, are taking a step back. In the current FSGO, the commentary to the definition of “an effective program,” provides that:

“An organization’s failure to incorporate and follow *applicable industry practice or the standards called for by any applicable governmental regulation* weighs against a finding of an effective program to prevent and detect violations of law.” (emphasis added)

This provision is removed from the Proposed Amendments, presumably because of the expanded definition of “violation of law,” but the expanded definition does not include industry practices as does the current guidelines.

Accordingly, for all these reasons, I strongly recommend that the Proposed Amendments be submitted with the changes suggested in the above table and my previously submitted recommendations. In sum, the recommendations in my testimony address three general areas:

- Provide for more proactive roles of the governing authority and organizational leadership: subsections (b)(2) and (b)(4)
- Link risk assessment, expected program outcomes, and program evaluation in §8B2.1(c)
- Provide a reference to “promises of anonymity and confidentiality, where appropriate and enforceable” as an element of a mechanism to encourage employees and agents to seek advice and report their concerns: subsection (b)(5).

## **II. Response to Issue Number 4: Provide a separate provision re: the challenges to the small to medium enterprise (SME)**

The Commission asked whether there were factors or considerations that could be incorporated into Chapter Eight (Sentencing of Organizations), particularly §8C1.2, to encourage small and midsize organizations to develop and maintain compliance programs?

**A. Propose a separate subsection (d) addressing the small to medium enterprise.** Domestically and around the globe, approaching ethics and compliance programs for the small to medium enterprise (SME) has been challenging. While there are references to these challenges throughout the guidelines, we recommend that an additional section, §8B2.1(d), be added to give specific guidance to the Federal judiciary. The Commission’s doing so will be

Testimony before the USSC  
17 March 2004  
Page 12

particularly helpful to those making the case for the SME ethics/compliance program as they will be able to point to a separate provision addressing the SME.

We recommend language and commentary covering the following points:

Each small to medium enterprise (“SME”)<sup>6</sup> is unique, often taking on the character of its owners and managers. SMEs often lack the capital, staff, or time of large, complex enterprises (“LCEs”) to address many business issues. Though many of the best practices developed over the last two decades reflect the experiences of these LCEs, the process of developing standards, procedures, and expectations is the same for all enterprises, though the answers for each enterprise will depend upon the size, complexity, and resources of the enterprise itself. To be deemed an effective program, a SME must have made a good faith effort to adapt the standards and best practices of LCEs to meet their circumstances, including the culture of the organization, the pressures of its business environment, and resources available, including its business associations and shared services.

**B. Propose an incentive to Large Organizations to support the small to medium business.** I am reluctant to propose that any business be required to design, implement, and enforce a program to prevent and detect violations of law on the part of another company—even a company in its supply chain. However, there is a growing movement known as “supply chain management”—generally seen as a part of what it means to be a socially responsible business—which addresses human rights, labor relations, environment, and quality issues. The Commission might propose a one-point reduction for organizations working with their substantial suppliers and service providers to develop, perhaps even integrate, their programs to prevent and detect violations of law.

**C. Work with or endorse governmental or non-governmental efforts to raise awareness of the issue and develop cost-effective tools for the SME to design, develop, and enforce such programs.** Following the model of the Commission’s Conference in 1995 on “Corporate Crime in America: Strengthening the ‘Good Citizen’ Corporation,” provide guidance, inspiration or support for agencies of the Federal government, such as the Small Business Administration and the Department of Commerce as a whole, to address the challenges to the small to mid-size business.

---

<sup>6</sup> There are many definitions of the SME, especially the small enterprise. The World Bank definition of the small enterprise is under 300 employees, while the U.S. Small Business Agency definition is 500 employees.

Testimony before the USSC  
17 March 2004  
Page 13

In our work on the forthcoming *Manual on Managing the Responsible Business Enterprise*, we addressed the issue of whether the U.S. experience was germane to the experiences, capital, and other resources of enterprises in emerging market economies. I included in my original comments of the Proposed Amendments a table from that work, which suggests how an SME might adapt the U.S. experience under the FSGO. A series of conferences might build off that table leading to a toolkit and resources. This might lead to a capability of the Small Business Development Centers in all fifty states and the District (sponsored by the SBA) to include, as a component of their advice, guidance toward designing and implementing an effective program to prevent and detect violations of law. It might ultimately lead to supporting provisions in the Federal Acquisition Regulations, and the various agency supplements that address are requirement for demonstration of organizational integrity as a condition of government procurement and contracting.

International experience suggests that another channel by which responsible business conduct can be encouraged is through the lending community. The European Bank for Reconstruction and Development, for example, performs extensive due diligence into the organizational integrity of participants before committing any funds to a project. Through the efforts of the Commission, having an effective program to prevent and detect violations of law could become one element of a criterion of organizational integrity for United States' grants, loans, or export credits to all business, including small to medium enterprises.

It is clear, in my view, that some Federal agency or agencies need to take the lead in encouraging Federal agencies to (1) offer incentives to encourage SMEs to develop effective programs and (2) help develop the tools necessary for them to meet this level of internal control effectively and at an acceptable cost. The Commission can once again serve as a catalyst to stimulate this leadership.

**III. Conclusion.** The Proposed Amendments represent a significant step forward for the FSGO. I appreciate this opportunity to augment our comments on the Proposed Amendments, and I will be happy to answer any questions you might have.