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Hallmark VI-Incentives and Discipline

A. Financial Incentives for Compliance

One of the areas that many companies have not paid as much attention to in their compliance programs is compensation. However, the DOJ and SEC have long made clear that they view monetary structure for compensation, rewarding those employees who do business in compliance with their employer's compliance program, as one of the ways to reinforce the compliance program and the message of compliance. As far back as 2004, former SEC Director of Enforcement Stephen M. Cutler noted that integrity, ethics and compliance needed to be part of promotion, compensation and evaluation processes: "At the end of the day, the most effective way to communicate that "doing the right thing" is a priority, is to reward it."

The 2012 FCPA Guidance stated the "DOJ and SEC recognize that positive incentives can also drive compliant behavior. These incentives can take many forms such as personnel evaluations and promotions, rewards for improving and developing a company's compliance program, and rewards for ethics and compliance leadership."

This same concept around compensation and incentives was brought forward in the Evaluation under Prong 8, Incentives and Disciplinary Measures:

> *How has the company incentivized compliance and ethical behavior? How has the company considered the potential negative compliance implications of its incentives and rewards? Have there been specific examples of actions taken (e.g., promotions or awards denied) as a result of compliance and ethics considerations?*"

In his 2015 *Harvard Business Review* article "The Right Way to Use Compensation," author Marc Roberge discussed a company's design and redesign of its employee's compensation system to help drive certain behaviors. The piece's subtitle indicated how the company fared in this technique as it read, "To shift strategy, change how you pay your team." The article lays out a framework for the chief compliance officer or compliance practitioner to operationalize compensation as a mechanism in a *best practices* compliance program.

As your compliance program matures and your strategy shifts, "it's critical that the employees who bring in the revenue-the sales force-understand and behave in ways that support the new strategy. The sales compensation system can help ventures achieve that compliance." The prescription for you as the compliance practitioner is to revise the incentive system to focus your employees on the goals of your compliance program. This may mean that you need to change the incentives as the compliance programs matures; from installing the building blocks of compliance to integrating anti-corruption compliance with the DNA of your company.

There are three key questions you should ask yourself in modifying your compensation structure. First, is the change *simple*? Second, is the changed *aligned* with your company values? Third, is the effective on behavior *immediate* due to the change?

Simplicity. Keep the compensation plan simple and even employee KISS, *keep it simple sir,* when designing your program. If you do not do so, your employees might fall back on old behaviors that worked in the past. Roberge notes, "It should be extraordinarily clear which outcomes you are rewarding." The simplest way to incentive employees is to create metrics that they readily understand and are achievable in the context of the compliance program. This can start with attending Code of Conduct and compliance program training. Next might be a test to determine how much of that training was retained. It could be follow up, online training. It could mean instances of being a compliance champion in certain areas, whether with your employee base or third-party sales force.

Alignment. As the CCO or compliance practitioner, you need to posit the most important compliance goal your entity needs to achieve. From there you should determine how your compensation program can be aligned with that goal. The beauty of this alignment is that it works with your sales force throughout the entire sales cycle. If your sales channel is employee-based, then their direct compensation can be used for alignment. However, such alignment also works with a third-party sales force such as agents, representatives, channel ops partners and even distributors. You can even introduce clawbacks, which would come into play at some point in the future for who might violate your compliance program.

Immediacy. It is important that such structures be put in place "immediately" but in a way that incentives employees. As a part of immediacy, there must be sufficient communication with your employee. In the world of employee compensation incentives, there should be transparency as to the expectations.

To these points, a panel at Compliance Week 2016, entitled "The Unsolvable Problem: Performance, Pay, Pressure and Misconduct" focused on variable compensation. The panel had some interesting thoughts around compensation, including the amount of your variable compensation relative to risk; What does your discretionary bonus program consist of? Is it corporate performance based? Group performance based? Solely personal (i.e., "eat what you kill")? Or is it some combination of all of the above?

The panel provided three examples of which might lead to compliance failures. (1) Lofty goals but no direction for employees on how to get there; (2) A paucity of communication between management and line employees, meaning there was raw fear from employees to inform their immediate supervisor of bad news. Conversely, it could be the supervisors who do not want to hear such bad news; and (3) If your company has singular focus on numbers, meaning that is the single judge of your worth as an employee. Answering some of these questions if they arise can help you to understand the design of incentive plans and allow monitoring of incentive plans to identify underlying links that may arise through compliance violations.

What about the inter-connectedness of senior management compensation in a compliance program. This was by Gretchen Morgenson, in a 2015 *New York Times* article entitled "Ways to Put the Boss's Skin In the Game," which dealt with a long-standing question about how to make senior executives more responsible for corporate malfeasance? Her article had direct application to compliance programs and compensation for senior management tied to compliance. Morgenson said the issue was “Whenever a big corporation settles an enforcement matter with prosecutors, penalties levied in the case—and they can be enormous – are usually paid by the company’s shareholders. Yet the people who actually did the deeds or oversaw the operations rarely so much as open their wallets.”

She went on to explain the economic phenomenon of “perverse incentives” wherein executives are encouraged to take excessive risk because they can profit so much from them, all while knowing they probably won’t have to pay any fines or face other costly consequences of their actions. To help remedy this situation, the idea has come to the fore about senior managers putting some “skin in the game.”

One solution came from William Dudley, the President of the Federal Reserve Bank of New York, whom Morgensen references in her column. The idea is that bank executives receive a performance bond for their actions; in the event of a large fine, those executives holding the bond must forfeit it. This would both discourage misbehavior (or poor risk-taking) spurred by perverse incentives, but it would give a proper incentive for personnel to point out troubling issues as they arise.

Obviously, the power of a compensation plan is to motivate salespeople not only to sell more but to act in ways that support your company’s business model and overall culture and values. For the compliance practitioner, one of the biggest reasons is to first change a company’s culture to make compliance more important, and then really integrate it into the fabric of your organization. But you must be able to evolve in your thinking and professionalism as a compliance practitioner to recognize the opportunities to change and then adapt your incentive program to make the *doing of* compliance part of your company’s everyday business process.

B. The Fair Process Doctrine

In the Department of Justice’s Evaluation of Corporate Compliance Programs, Prong 8 Incentive and Disciplinary Measures states:

> *Have the disciplinary actions and incentives been fairly and consistently applied across the organization?*

Similarly, the FCPA Corporate Enforcement Policy states:

> *Appropriate discipline of employees, including those identified by the company as responsible for the misconduct, either through direct participation or failure in oversight, as well as those with supervisory authority over the area in which the criminal conduct occurred.*

Hallmark Six of the Ten Hallmarks of an Effective Compliance Program states:

> *In addition to evaluating the design and implementation of a compliance program throughout an organization, enforcement of that program is fundamental to its effectiveness. A compliance program should apply from the board room to the supply room—no one should be beyond its reach. DOJ and SEC will thus consider whether, when enforcing a compliance program, a company has appropriate and clear disciplinary procedures, whether those procedures are applied reliably and promptly, and whether they are commensurate with the violation. Many companies have found that publicizing disciplinary actions internally, where appropriate under local law, can have an important deterrent effect, demonstrating that unethical and unlawful actions have swift and sure consequences.*

The 2012 FCPA Guidance's best practices are more likely to gain results than the "stick" of employee discipline to make a compliance program effective. But this does require a "carrot" to work, and such a thing is codified in the U.S. Sentencing Guidelines with the following language:

> *The organization's compliance and ethics program shall be promoted and enforced consistently throughout the organization through a) appropriate incentives to perform in accordance with the compliance and ethics program; and b) appropriate disciplinary measures for engaging in criminal conduct and for failing to take reasonable steps to prevent or detect criminal conduct*.

One of the areas which Human Resources can operationalize your compliance program is to ensure that discipline is handed out fairly across an organization and to reward those employees who integrate such ethical and compliant behavior into their individual work practices going forward. In addition to providing a financial incentive for ethical behavior, it also provides a sense of institutional objectivity. Institutional objectivity comes from procedural fairness and is one of the things that will bring credibility to your compliance program.

Today, that kind of objectivity is called the Fair Process Doctrine, which recognizes that there are fair procedures, not arbitrary ones, in processes involving rights. Considerable research has shown that people are more willing to accept negative, unfavorable, and non-preferred outcomes when they are arrived at by processes and procedures that are perceived as fair. As you incorporate the Fair Process Doctrine in your compliance program, there are three key areas to focus on.

Administration of discipline. One area where the Fair Process Doctrine is paramount is in the administration of discipline after any compliance related incident. Discipline must not only be administered fairly but it must be administered uniformly across the company for the violation of any compliance policy. If you are going to fire employees in South America for lying on their expense reports, you have to fire them in North America for the same offense. It cannot matter that the North American employee is a friend or a so-called "high producer." Failure to administer discipline uniformly will destroy any vestige of credibility that you may have developed.

Likewise, there must be real consequences to employee who violate your compliance program. If the regulators come knocking and you have not disciplined any company employees for Code of Conduct or compliance program violations in multiple years, the DOJ and SEC will conclude pretty quickly you are not serious about compliance. Fair process means that you must discipline those who engage in compliance violations no matter what their position is with the organization.

Employee promotions. In addition to the area of discipline which may be administered after the completion of any compliance investigation, you must also place compliance firmly as a part of ongoing employee evaluations and promotions. If your company is seen to advance and only reward employees who achieve their numbers by whatever means necessary, other employees will certainly take note and it will be understood what management evaluates, and rewards, employees upon. A commonly heard response to this is, “If I get caught I may or may not be disciplined. If I miss my numbers for two quarters, I will be fired.” If this is what other employees believe about how they are evaluated and the basis for promotion, you cannot win the compliance battle until this mindset is addressed.

Internal investigations. The third area the Fair Process Doctrine is critical in, is around internal company investigations. If your employees do not believe that the investigation is fair and impartial, then it is not fair and impartial. Further, those involved must have confidence that any internal investigation is treated seriously and objectively. One of the key reasons that employees will go outside of a company’s internal hotline process is because they do not believe that the investigation process will be fair.

This fairness has several components. One would be the use of outside counsel, rather than in-house counsel to handle the investigation. Moreover, if company uses a regular firm, it may be that other outside counsel should be brought in, particularly if regular outside counsel has created or implemented key components which are being investigated. Further, if the company’s regular outside counsel has a large amount of business with the company, then that law firm may have a very vested interest in maintaining the status quo. Lastly, the investigation may require a level of specialization which in-house or regular outside counsel does not possess.

An often-overlooked role of any CCO or compliance professional is to help provide employees procedural fairness. If your compliance function is seen to be fair in the way it treats employees, in areas as varied as financial incentives, to promotions, to uniform discipline meted out across the globe; employees are more likely to inform the compliance department when something goes array. If employees believe they will be treated fairly, it will go a long way to more fully operationalizing your compliance program.