With the regulatory environment hotter than ever, a strong internal controls program is a necessity. Directors should evaluate their audit department and IT systems to determine current capabilities and decide how to leverage their budget and personnel most advantageously. It’s the board’s responsibility to ensure the integrity of auditing procedures and the internal investigation process before encountering regulatory scrutiny.

In Corporate Board Member’s 2012 Boardroom Liabilities roundtable, our panelists offer their take on the current landscape and how best to monitor compliance and mitigate risk.

To begin, would each of you briefly discuss your view of the landscape and explain why regulatory investigations are a critical topic for public company boards right now?

**Holly Gregory:** Regulatory investigations and the issues underlying them can pose significant risks to a company, and boards need to be paying attention to risk and to red flags, including the fact of an investigation and any early warnings leading up to an investigation that might lead to this situation. The board must ensure that reasonable compliance and information and reporting systems are in place, with sound processes and procedures, so that if something does go wrong, it will be handled appropriately.

**David Holley:** In assessing these situations, we’ve seen that great weight is given to monetary issues around the risks, but you can’t stress enough the gravity of reputational risk. Those risks are really hard to recover from when something goes wrong in a regulatory context. We also can’t overemphasize the collateral damage surrounding risks of reputation, such as loss of business, inability to bid on government projects, and the retention of good people, although these are probably the last things to be thought of until a company is considering what to do in a crisis.

**Steve Fagell:** Yes, the intangible risks need to be front and center. They’re risks that, as David said, can continue to present themselves with lasting negative impacts for years after the actual regulatory investigation is settled. Also, because of the way regulatory investigations have been resolved in recent years, particularly with the rise of deferred-prosecution agreements and nonprosecution agreements, the directors themselves can suffer these impacts. For example, if a company is faced with having to engage an independent compliance monitor, that arrangement could directly impact the typical oversight that a board of directors would normally give to the company. So directors have to realize that it’s financial risk, it’s reputational risk, it’s all sorts of other intangible risks, but ultimately, it can also negatively affect the way the board does its job as overseer of the corporation.

**Mark Curley:** I would only add a couple of things as far as the current regulatory landscape is concerned. First, regulators are more active now at the federal and state level, and they are reasonably well funded and motivated, at least to some extent, by the prospect of monetary settlements as well as the publicity that follows. Also, because of the way regulatory investigations have been resolved in recent years, particularly with the rise of deferred-prosecution agreements and nonprosecution agreements, the directors themselves can suffer these impacts. For example, if a company has subsidiaries or divisions abroad, it is critical that the same level of compliance and control exercised in the United States be exercised abroad. There are a number of regulatory investigations that appear to have gone right and certainly others that have not. Are there common threads you see that make the difference between a “successful” and “unsuccessful” regulatory investigation?
Fagell: As a threshold matter, it is important that the expectations of the board and senior management are aligned. This is especially important as companies consider whether or not to voluntarily disclose possible misconduct to the government. Some companies make the decision to voluntarily disclose, expecting that the disclosure will result in a declination to prosecute or will lead to a more favorable settlement. And that can happen. But it’s also the case that a company may end up with buyer’s remorse as the government demands a far more expansive and involved investigation than the company ever contemplated. Or the government may conclude that, in fact, the voluntary disclosure was not “voluntary” in their view. The point here is that the effects of these disclosures are unpredictable, and that should be well understood by the board.

Curley: In the age of for-profit whistleblowers, which is what we are going to see more often in the wake of Dodd-Frank, companies may be less likely to avoid disclosure anyway, whether it’s ultimately seen as voluntary or not.

Gregory: When an investigation is needed, the board should pay special attention to whether it can be handled in-house, along with regular outside counsel, or whether an in-depth investigation is required. An appropriate approach and tone will help mitigate the outcome. It’s difficult enough to predict what will happen when you’re discovering facts in real time. Although the facts will ultimately determine the course, so much of the outcome is built around this notion of tone, meaning how you approach the process—how to communicate your cooperation and make sure that regulators know that the board is paying attention and taking this seriously at the highest level of the company. Setting the right tone is a hard thing to do as a director, because often there are executives, with reputations on the line, who may push back, but setting an agreeable, cooperative tone is a crucial board responsibility.

Fagell: You raise an important point, Holly. Internally, it’s very important that the board, the CEO, the general counsel, and outside counsel are all on the same page as to the strategy with the government and the ultimate objectives for resolving the matter, including the timing. In one recent matter, the board stepped in and hired Covington to replace the prior investigative team after becoming frustrated by how long the internal investigation was taking and the seeming lack of progress with the government. It’s never a good outcome for anyone if the board feels frustrated by the process and misaligned with what the general counsel is trying to do in managing outside counsel. The onus falls on the GC and the CEO to keep the board appropriately informed, but it’s ultimately the board’s responsibility to ensure the integrity of the internal investigation and to ensure the strategy being pursued is in the best interest of shareholders.

Holley: One of the things we’re talking about is the investigation’s acceptance by its intended audience. Whether the investigation is focused on reporting to the board, the regulators, or the general public, the report and the statements that surround the investigation have to be believable. I think one of the biggest factors relating to that consideration is the independence of the group that conducted the investigation. We can circle back to Enron and agree that some of the initial investigations were conducted by inside individuals who were not in the best position to do the reporting. So the independence of the firm or group that does the internal investigation is crucial. The more independent the investigation, the more willing outside parties will be to accept the findings.

Curley: That’s very true, and really analogous to the work of a special litigation committee established to address a shareholder derivative demand. If the investigation is performed in a sufficiently independent manner, its findings are more likely to carry the day with a reviewing court or, in this case, a regulator. But this also may be accompanied by a loss of control on the part of those directors not actually part of the independent committee. And when an investigation is outside the normal control of the board and/or management, it can get extremely expensive, very quickly.

FCPA investigations have taken center stage recently. What can companies do to prevent becoming embroiled in these costly and damaging investigations?

Gregory: Invest in your compliance systems—certainly in the interest of preventing a FCPA violation, but also because having a robust internal compliance system will help with early reporting and with your ability to do your own investigation, making those decisions about self-reporting more efficient. Just this last April, there was an FCPA case in which the DOJ and SEC decided not to charge a company based solely on the strength of its compliance program.

Fagell: You are referring to the Morgan Stanley case, which was the first time the Department of Justice referred to a company’s compliance program in its decision not to bring charges. So there’s no question that investing in a
compliance program is the right headline, but beyond that, it’s very important that the compliance program be
tailored to the company’s risk profile, backed by rigorous training, and subject to a robust set of internal and
auditable controls. State-of-the-art compliance today for multinational corporations is not simply a mention of anti-
corruption in the code of conduct or merely the existence of a standalone anti-corruption policy, it’s actually having
a system of controls in place that internal audit can go in and audit as part of its regular exercise. That’s how you
ensure that you’re both preventing on the front end and checking on the back end.

The other thing I’d add is that once a company is embroiled in an investigation, the key is to develop a productive
dialogue with the government as to the scope of the investigation. Interestingly, one of the best ways to manage the
scope is to already have a robust, anti-corruption compliance program in place. Having that program in place will
help gain the government’s confidence that the matter in question can truly be isolated to, let’s say, one country or
one employee. Without the A+ program to hang your hat on, it becomes much more difficult to convince the
government that it doesn’t need to turn over other stones.

Holley: It is imperative that companies have a good understanding of their universe of third-party relationships.
This understanding must include who these parties are, their ownership structure, their degree of government
involvement, and whether they are capable of undertaking the assignments they have been retained to provide.
While this is generally a good path to staying out of harm’s way in the context of the FCPA, we also know that
counterparty due diligence is plain old best practice. So, whether you’re forming a joint venture or acquiring a
business or retaining an overseas agent, there should always be a degree of due diligence involved.

Curley: Going back to something I mentioned earlier, directors need to understand that the regulators and criminal
authorities in many countries have gotten involved in dealing with international bribery issues, including some of
the countries where we might historically have thought about bribery as part of the cost of doing business. While
this is hopefully a good development in the long run, transparency and competitiveness-wise, American companies
should keep in mind that an FCPA settlement in the U.S. may only be the first step in resolving a foreign bribery
case overall.

Turning to the issue of cost containment, do you have advice to assist boards with maximizing their in-house legal
spend?

Fagell: That question actually lends itself to an answer on the front and back end. What I mean is that you start from
the premise that investigations are not “one-size-fits-all” and not every allegation requires engagement of outside
counsel, forensic auditors, other third-party providers, etc. On the front end, companies want to ensure a rational
compliance structure. You want to make sure that key geographies are covered, that there’s an orderly process for
allegations to bubble up to corporate executives and to the board. So, boards should look now—before they have an
issue—at their internal audit department and IT systems in order to determine their capabilities and how best to
leverage the in-house spend. Does internal audit have the internal resources and know-how to conduct a thorough,
efficient forensic investigation, one that’s focused on anti-corruption red flags in the books and records and internal
controls? If so, it may well be that internal audit can work alongside outside counsel, even if a decision is made to
bring outside counsel in. Does the company have the IT capabilities to collect emails remotely, wherever they’re
located, and in a manner consistent with data privacy laws? There are certain functions that can be done very ably
inside the corporation. However, you’re not going to get there if you haven’t given thought to it on the front end.
Once the allegations have come in, I think the key is early assessment of the allegations and scoping out the
investigation in a way that’s well calibrated to the issue. Ultimately, the goal is to do what’s necessary to get smart
quickly and efficiently.

Holley: And when it’s time to think about outside service providers for various aspects of an investigative effort, I
recommend retaining experts who can provide more than one service and can provide some economies of scale,
whether it be geography or skill sets. For example, can our investigative service provider also assist with computer
forensic support and forensic accounting assistance? Take a measured approach as you try and reduce transaction
costs of multiple service providers. Don’t always leave it in the hands of your outside counsel to take those things
into consideration. Try to have a workable approach as to which law firm to call if something happens. In addition,
consider which geographic or expertise areas the law firm is or is not an expert in. Ask yourself, “What am I going
do in this instance, and what is the protocol that we have internally for dealing with this issue?” I think it’s
tempting not to think about those things until you have a problem, but it is wise and economical to have a strategy in
place in advance.
Gregory: I agree with purposing people within the audit and investigations team to be able to do multiple things. Many companies have people who can do some types of internal investigations already, so think about readiness and who would be right for some of the big investigations that could come down the pike. Of first importance is to get your arms around the facts and determine whether the issue at hand is big or small. That’s the immediate challenge, to assess the size of investigation needed. Companies often make the mistake of starting in slowly, doing a little bit of investigation, and before you know it, it’s gotten much bigger than the measures they had chosen to address it. Unfortunately, it can then spiral out of control.

Curley: In addition to all of these comments, I would be remiss if I didn’t mention that there are insurance products available that may help in dealing with the economic impact of an internal or external investigation. The better products also are backed by claims professionals with experience in dealing with many aspects of these investigations, as well as close connections with outside counsel and other service providers who can move the process forward as efficiently as possible.

To summarize your thoughtful comments, could you each offer your most cogent advice for boards in the coming year regarding the readiness of their compliance programs? What are the hot spots directors should be asking management to avoid to ensure they stay out of the investigation spotlight in 2013?

Gregory: The board should ask management: “What is your assessment of the area of greatest compliance risk, and how have you tailored our compliance and information system to address those risks?”

Holley: And what would naturally follow is to ask whether the compliance and information system works. Does the board know whether it’s effective? Is it being tested? An integrity hotline is a good example. A lot of companies have them, but we’ve learned that they’re mainly used to complain about 401(k) performance. So, you must ask probing questions: Are these systems being used properly? Are they being well published within the organization so that everyone knows they are available and useful? Is there an appropriate method to follow up so employees know the hotline is being taken seriously? Is there a matrix that describes each call into the hotline, how it was handled, what follow-up was undertaken, and the resolution so that we can judge effectiveness? Best practice encourages you to really test the systems the company has spent money to put in place. Having a proactive, internal evaluation is really important, and as both my colleagues here expressed, it resonates with regulators.

Fagell: I would also encourage board members to think about the life cycle of risk that any corruption issue presents, both on the compliance side and the enforcement side. Ultimately, it’s the board that has to ensure that the investigation is under the appropriate authority within the corporation and that the investigation is being conducted with the requisite independence and integrity. The board has to think about the disclosures to the government and to other constituents like shareholders, outside auditors, the Hill—if there’s potential congressional interest—and the general public. All of those swirling currents have to be thought of, and they have to be thought of early and often.

Curley: I would only add that board members should also be assured that the company’s risk management function is providing them with adequate coverage, not only in terms of dollar amount, but also ensuring that the risks faced by the directors themselves—separate and apart from those faced by the company or shared between the directors and the company—are being adequately addressed.

Ten Questions Boards Should Ask Management

1. Are our compliance systems well published and being used properly?

2. Is there an appropriate method to follow up so employees know that the hotline is being taken seriously? Is there a matrix so that we can judge effectiveness?

3. Is our anti-corruption compliance program based on a careful risk assessment of our industry and market?

4. Do we have standalone anti-corruption policies that address our key risk areas and that are supported by auditable controls?

5. Do we train and communicate with our personnel effectively on the risks we face?
6. Do we have a standard and auditable process in place for vetting our third-party intermediaries?

7. What do we do in terms of vetting and conducting pre-acquisition, anti-corruption due diligence, as well as post-acquisition integration of our transaction targets into our anti-corruption compliance program?

8. Do we have a protocol, informed by objective criteria, for when and how allegations are brought to the attention of the board?

9. Does the compliance function have sufficient direct access to the board and clout within the organization?

10. Do we have a whistleblower response plan, including factors to consider in deciding whether to make a voluntary disclosure?

*topic tags: board of directors, corporate governance, legal, regulatory*