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CORPORATE GOVERNANCE

Pre-IPO and newer public companies often underestimate the risks of compliance failures, letting compliance efforts lag behind business operations. This creates a ''compliance gap'' with potentially devastating consequences.

Avoiding the 'Compliance Gap': Newer Companies Should Not Underestimate the Risks of Compliance Failures

BY WILLIAM P. KEANE AND BEN GEIGER

Although companies of all sizes can experience compliance problems, companies that recently have gone public face unique compliance challenges in scaling up from pre-IPO shops. First, the very attributes of leanness, laser focus on product viability and flexible organizational structure that startups and early-stage companies need to succeed limit the resources and attention necessary for robust regulatory compliance, creating a ''compliance gap.'' Second, companies in their early years of public trading are uniquely vulnerable to both the cost and collateral consequences of a regulatory inquiry, such as de-listing, shareholder lawsuits, breached loan covenants, removal of key personnel and friction on business operations. In short, pre-IPO and newer public companies have further to go and more to lose when it comes to compliance.

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Private practitioners conducting internal investigations, government enforcement agencies, compliance specialists and academics are generally unanimous that a shift in company culture is required to close this compliance gap. The million dollar question, of course, is: ''how?'' This article describes the compliance challenges facing newly public companies and offers some observations, based on the authors' on-the-ground experience, about developing a robust compliance program.

Regulators Knocking at Your Door: The Consequences of a Compliance Gap

Imagine you are the chief financial officer of a $500 million/year tech company that went public three years ago. One morning you get a call from an enforcement attorney at the Securities and Exchange Commission saying she has received a tip through the SEC's whistleblower hotline about questionable payments to Russian government officials. These officials were in charge of deciding who will win a computer hardware supply contract on which your company has bid. She asks whether your company was aware of the payments, and you inform her that you will look into this and get back to her promptly.

Nine months later, your company has had to conduct a thorough internal investigation, publicly disclose an

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SEC investigation, cancel several contracts in Russia, hire a new accounting firm to determine the impact on all Russian government contract revenue, miss two 10-Q filing deadlines while the financial statements are scrutinized, breach loan covenants because of those missed financials, find new financing options, make insurance claims for the costs of the investigation, make more insurance claims to pay for separate counsel for a few individual employees, pay increased insurance premiums and appear before the New York Stock Exchange twice to beg for mercy from the threat of delisting.

How likely is this to happen at your company? Consider the following. Although statistics on internal investigations are notoriously difficult to compile given their confidentiality, a 2014 Norton Rose Fulbright survey of more than 400 in-house counsel found that 53 percent of companies with revenues of $100 million to $999 million hired outside counsel to assist with a government or regulatory investigation in the last 12 months. That figure was 40 percent for smaller companies and 74 percent for larger companies.[1] Although not all small or midsize companies are pre-IPO or newly public, this statistic dispels the notion that a company can slip under the regulatory radar merely because its market capitalization is under $1 billion.

More Whistle-Blowers, Greater Regulation

What is behind the prevalence and increasing frequency of internal investigations? One explanation is the variety of federally authorized whistle-blower programs that incentivize employees and former employees to go directly to the government with potentially incriminating information. Recently, the Dodd-Frank Wall Street Reform and Consumer Protection Act authorized a whistle-blower ''bounty'' program for the SEC. Under that program, a whistle-blower will receive 10-30 percent of the money that the SEC or other enforcement agencies collect if the whistle-blower provides high-quality, original information that leads to more than $1 million in sanctions.[2] By last September, the SEC had already received 3,238 tips during the preceding year, even though the number and amount of resulting awards remained small.[3] In October 2013, however, one whistle-blower received a $14 million award.[4] This June, another two whistle-blowers shared $875,000,[5] and on July 31, a whistle-blower received a $400,000 bounty.[6]

Furthermore, the Internal Revenue Service, the Commodity Futures Trading Commission and other federal agencies have their own whistle-blower programs (some limited to protections against employer retaliation). And the newer bounty programs have expanded the areas of potential whistle-blower cases for the plaintiffs' bar. The result? Employees who are now highly incentivized to blow the whistle also have plaintiffs' lawyers ready and eager to help them, often on a contingency basis.

Nor are plaintiffs' lawyers and employees the only ones getting more aggressive. In April 2013, the SEC replaced its outgoing chairman with Mary Jo White, the former chief federal criminal prosecutor for the most active white-collar-fraud district in the country, the U.S. District for the Southern District of New York. Although the jury is still out on what Mary Jo White's legacy will be, the SEC's enforcement efforts have since become more aggressive in requiring more defendants to admit wrongdoing as part of settling charges.[7] In addition, Congress increased the SEC's budget by almost 42 percent over five years—from $953 million in 2009 to $1.35 billion in 2014.

Although enforcement action against bigger companies tends to send a louder deterrence message to the business community, the chief of the SEC Enforcement Division's FCPA Unit, Kara Brockmeyer, recently underscored that the SEC will direct its enforcement efforts to smaller companies as well. Referring to the SEC's settlement of FCPA charges against Smith & Wesson, a mid-sized company with annual revenue of $626 million as of April 30,[8] Brockmeyer said, ''This is a wake-up call for small and medium-size businesses that want to enter into high-risk markets and expand their international sales. When a company makes the strategic decision to sell its products overseas, it must ensure that the right internal controls are in place and operating.''[9]

The Severe Damage of Violations To Pre-IPO and Newer Public Companies

In light of increased whistle-blower incentives and more aggressive government investigations, companies today are more likely choose to voluntarily investigate and self-report potential violations to regulators. Not always, but it often behooves a company to get ahead of potential compliance violations by being the first to re-

[1] Norton Rose Fulbright, *Norton Rose Fulbright's Annual Litigation Trends Survey* (Apr. 15, 2014), *available at* http://www.nortonrosefulbright.com/news/115212/norton-rose-fulbrights-annual-litigation-trends-survey.

[2] *See* Implementation of the Whistleblower Provisions of Section 21F of the Securities Exchange Act of 1934, Exchange Act Release No. 34-64545 (May 25, 2011) at 3, *available at* http://www.sec.gov/rules/final/2011/34-64545.pdf.

[3] U.S. Sec. & Exch. Comm'n 2013 Annual Report to Congress on the Dodd-Frank Whistleblower Program 8 (Nov. 15, 2013), *available at* http://www.sec.gov/about/offices/owb/annual-report-2013.pdf.

[4] U.S. Sec. & Exch. Comm'n, Release 2013-209, *SEC Awards More Than $14 Million to Whistleblower* (Oct. 1, 2013), *available at* http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370539854258#.U9h0feNdWNE.

[5] U.S. Sec. & Exch. Comm'n, Release 2014-113, *SEC Awards $875,000 to Two Whistleblowers Who Aided Agency Investigation* (June 3, 2014), *available at* http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370541980219#.U9hyduNdWNE.

[6] U.S. Sec. & Exch. Comm'n, Release 2014-154, *SEC Announces Award for Whistleblower Who Reported Fraud to SEC After Company Failed to Address Issue Internally* (July 31, 2014), *available at* http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370542578457#.U9vZPONdVX4.

[7] U.S. Sec. & Exch. Comm'n, Release 2013-264, *SEC Announces Enforcement Results for FY 2013* (Dec. 17, 2013), *available at* http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370540503617#.U9vYFONdVX4.

[8] Smith & Wesson Holding Corp., Annual Income Statement, *available at* http://ir.smith-wesson.com/phoenix.zhtml?c=90977&p=irol-fundIncomeA.

[9] U.S. Sec. & Exch. Comm'n, Release 2014-148, *SEC Charges Smith & Wesson with FCPA Violations* (July 28, 2014), *available at* http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370542384677#.U9var-NdVX4.

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port to regulators, demonstrating a proactive investigation and showing plans for remedial action. As a result, the more likely a regulator is to hear first from a company employee, the greater the potential need to self-report.

Any seasoned in-house counsel or internal investigator will say that even meritless whistle-blower tips can create a major expense and distraction. If an enforcement agency does approach your company about a tip that ultimately proves meritless, you will still need facts to refute it. In presenting those facts to the regulators, you will need to show you looked at all potentially relevant information. That means, at a minimum, searching for, collecting and reviewing all relevant documents and e-mails about the alleged issue, interviewing witnesses and reporting the results back to the agency—and fast. Assuming your company does not have the personnel for this, the average partner at a 1,000-plus attorney firm billed $727/hour in 2013,[10] so even a relatively modest team of four attorneys working full time on a ''short'' investigation spanning one-to-two months will quickly add up. Add in charges for a document review team, the technology to host a large database of documents, possible forensic accountants and your lawyers' time for presenting the results of the investigation to regulators, and costs can dig painfully into your bottom line—even for that meritless tip.

If the investigation does find a potential violation, regulators may seek civil penalties or even criminal charges. Even when a violation was the result of a rogue employee or group of employees, regulators tend to blame the company for failing to detect and deter the wrongdoing. Penalizing companies also provides a greater deterrent effect for the rest of the business community, and larger penalties better justify the regulators' own budget requests to Congress.

How much can these penalties be for companies with less than $1 billion in revenue? In July, the SEC announced that it settled claims of FCPA violations against Smith & Wesson, discussed above, for $2 million.[11] In June, the SEC announced that a Massachusetts federal court ordered AutoChina International Limited, a China-based company with 2013 revenues of $658 million, to pay $4.35 million for manipulating its stock price.[12] At the high end, the penalty numbers are dizzying. In June, the U.S. Department of Justice announced that BNP Paribas agreed to plead guilty to helping clients violate U.S. sanctions on Iran, Sudan and other countries, and to pay an $8.9 billion criminal penalty.[13]

Penalties aside, companies must consider the collateral damage of an actual compliance violation. Many violations affect the accuracy of a company's past financial statements. Identifying and correcting every material inaccuracy can require further forensic accounting review and, more critically, considerable time. Without accurate financial statements, a public company cannot file its 10-Qs and 10-Ks, and risks de-listing from its public exchange. Public or private, a company's loan covenants typically require it to provide its bank with up-to-date financial statements. The longer it takes to resolve an accounting issue, the greater the jeopardy to a company's liquidity. Further, company officers, directors, and employees, and increasingly companies themselves, face criminal liability for compliance violations. Typically, violations must be ''willful'' to be criminal, a high bar for prosecutors. But in the age of e-mail and instant messaging, damning evidence is often documented and therefore only a keyword search away.

Startups and newer companies should be aware that this fast slide from publicly listed to very publicly delisted can be just a few wayward employees and several months away. These threats make a robust compliance program a fact of life for any company, especially a public company or a private company looking to be acquired by a public company. Not only do compliance programs help to catch violations before they happen, but when a violation does happen, evidence of a well-planned, well-executed compliance program will serve as a mitigating factor with regulatory agencies deciding whether to charge and, if so, what penalty to seek.

Growing Businesses and The Culture of Risk-Taking

Although regulatory scrutiny and the downside risk of an investigation should encourage new companies to think about compliance early on, younger companies tend to experience compliance gaps for several reasons. In the fiercely competitive startup world, startup management may believe that spending substantial time and resources on corporate governance at the expense of product development risks the product evolution necessary to grow beyond seed financing. Even companies with a few rounds of financing under their belts will often tell say they can rarely afford to dedicate precious dollars to hire a general counsel or compliance officer. Getting products to market is a life-or-death matter for newer companies.

This necessary focus on product development can become engrained in company culture. Senior leadership can be dominated by company founders and early-stage employees who are used to operating as a fast-paced startup and bristle at putting internal controls and risk management processes in place. Decentralized, non-hierarchical organizations also have trouble implementing uniform policies. A lack of compliance training for employees can allow business units to develop their own culture and workarounds for situations requiring more deliberate solutions. Having underdeveloped internal controls also means that a midsize company faces more time and money to get up to speed with its growing operations. And most startups experience their

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[10] Debra Cassens Weiss, *Average Hourly Billing Rate for Partners Last Year Was $727 in Largest Law Firms*, ABA Journal (July 15, 2013) (citing a national survey by Tymetrix Legal Analytics and CEB of invoices from 4,800 law firms spanning 2008–12), *available at* http://www.abajournal.com/news/article/average_hourly_billing_rate_for_partners_last_year_was_727_in_largest_law_f/.

[11] *Id.*

[12] U.S. Sec. & Exch. Comm'n, Litigation Release No. 23033, *Court Enters Judgments Against China-Based Company and Senior Executive in Market Manipulation Scheme; Company Ordered to Pay $4.35 Million Penalty* (June 27, 2014), *available at* http://www.sec.gov/litigation/litreleases/2014/lr23033.htm.

[13] U.S. Dep't of Justice, *BNP Paribas Agrees to Plead Guilty and to Pay $8.9 Billion for Illegally Processing Financial Transactions for Countries Subject to U.S. Economic Sanctions* (June 30, 2014), *available at* http://www.justice.gov/opa/pr/2014/June/14-ag-686.html.

early growth with no risk-focused personnel like in-house counsel or compliance officers.

Indeed, in the high-tech business world, the acceptance of risk-taking on the business side has progressed to the point that many entrepreneurs view failure as a necessary and even helpful component of doing business. Under the ''lean startup'' movement that many emerging companies have embraced, for instance, companies will bring to market only a ''minimum viable product'' and plan for constant product revision at the early stages. Product failure is not to be avoided; it is a source of data for innovation. This view can persist in midsize tech companies. For instance, in the software design process, companies assess whether they are using appropriate safeguards by asking whether a software design protection's cost to the company in friction, morale and entrepreneurialism outweighs the benefit of the reduced risk. If the risk being guarded against is not catastrophic, then companies have to consider taking it, even if it will likely lead to a software failure. Headlines over the last few years also have noted that having started or worked at a failed startup is now considered a badge of honor to many in the high-tech world.[14]

For a new or growing company, business risk, even to the point of product or company failure, is a risk that must be tolerated. The challenge, however, is to keep attitudes about business risk from spilling over to policies and practices addressing compliance risk, which must be viewed differently. Realized compliance risk does not just end companies, it also jeopardizes careers and the personal liberty of a company's leaders. In all businesses, growing or established, there is a fundamental tension between the different approaches required to manage business risk and compliance risk. Growing businesses, however, can have a harder time striking the right balance because they may believe they cannot afford to invest in a compliance culture.[15]

Closing the Compliance Gap

To consider how your company's compliance program stacks up, checklists for compliance programs abound. Although tailored to the Foreign Corrupt Practices Act, the guidance put out by the SEC and DOJ in their joint 2012 publication A RESOURCE GUIDE TO THE U.S. FOREIGN CORRUPT PRACTICES ACT is nevertheless widely applicable to compliance and one of the most authoritative compliance checklists.[16] These can be helpful resources, but we offer here several observations that are directed at pre-IPO and newer public companies, and are not typically found in the checklists.

[14] *See, e.g.*, Krissy Clark, *Your Start-Up Failed. Congratulations!*, MARKETPLACE WEALTH & POVERTY (Jan. 28, 2014), *available at* http://www.marketplace.org/topics/wealth-poverty/your-start-failed-congratulations.

[15] Law professors and sociologists also have noted that companies in high-growth industries may tend to have weaker internal controls. *E.g.*, D. Daniel Sokol, *Policing the Firm*, 89 NOTRE DAME L. REV. 817 n.170 (2013), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2230121##.

[16] U.S. DEP'T OF JUSTICE AND U.S. SEC. & EXCH. COMM'N, A RESOURCE GUIDE TO THE U.S. FOREIGN CORRUPT PRACTICES ACT (Nov. 14, 2012), *available at* http://www.justice.gov/criminal/fraud/fcpa/guidance/. Chapter 5 contains a discussion of the ''Hallmarks of Effective Compliance Programs.''

1. Start Now

Despite the fact that compliance is not technically difficult to put into place, particularly compared to the stunningly complex product challenges that today's companies are solving all the time, smart newly public companies still suffer compliance failures. This is not because it is difficult to figure out what compliance measures are needed, but because many companies find it difficult to direct the necessary attention and resources on compliance before a problem emerges. But the time to address your compliance gap is before you get the call from the whistle-blower (or the government attorney), not after.

Like any preventive practice, the sooner you do it, the easier, cheaper and more effective it will be. Growing companies that recognize early on that they will have to address their compliance gap and implement compliance measures deliberately will have fewer and less costly growing pains along the way.

2. Recognize That as Company Grows, Risk Is Harder to See

Company founders have known the company from its first days as a much simpler organization. Smaller companies where everyone knows what everyone else is up to require fewer internal controls and governance mechanisms. But as the business grows, its products and org chart become more complex. These changes not only decrease leadership's ability to manage potential problems, they decrease leadership's ability to see them. This is not a problem with a one-stop solution. Indeed, it is one of the basic reasons for internal controls and compliance programs.

3. Address 'Tone at the Bottom'

Although one compliance mantra rightly touts the importance of the ''tone at the top'' articulated by company leadership, company culture also develops within frontline work units. As Columbia University sociologist Diane Vaughan wrote in her definitive book on NASA and the *Challenger* disaster:

> A culture is a set of solutions produced by a group of people to meet specific problems posed by the situations that they face in common. These solutions become institutionalized, remembered and passed on as the rules, rituals, and values of the group. Culture is sometimes falsely assumed to be a characteristic peculiar to a formal organization as a whole. This may be the case when the organization is small and has a simple structure. But most organizations are segmented and potentially have as many cultures as subunits.[17]

In other words, subunits form their own cultures, including their own solutions to business problems. This reality can be easy for growing companies to miss because they are less familiar with managing and training diverse subunits. One-size-fits-all compliance training may not be effective. Instead, companies should assess which subunits present the greatest compliance risk and provide tailored, small-group training to them. Vaughan's analysis also suggests that the importance of compliance programs is that they can redefine the ''rules, rituals, and values'' that subunits employ to decide what business solutions are acceptable.

[17] DIANE VAUGHAN, THE CHALLENGER LAUNCH DECISION 64 (The University of Chicago Press, 1996).

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4. Shape Employees' Work Environment

A related lesson from academia and our experience on the ground is that ''good people'' can and do make bad, costly decisions. Although unethical employees willing to compromise their own and the company's ethics sometimes surface, employees with every indication of being upright and honest also commit compliance violations. One reason is that the organizational environment in which employees make business decisions can have a huge influence on decisionmaking, and in some instances can even lead errant employees to genuinely believe they are doing the right thing. As Professor Vaughan has put it:

> The answer to the question of ''good'' people and ''dirty'' work suggested by this research is that culture, structure, and other organizational factors, in combination, may create a worldview that constrains people from acknowledging their work as ''dirty.'' Thus, rather than contemplating or devising a ''deviant'' strategy for achieving the organization's goals and rationaliz[ing] it afterward, they may never see it as deviant in the first place.[18]

Vaughan found that the errors leading to the *Challenger* disaster were not the result of a calculated cost-benefit risk assessment by managers willing to violate NASA's internal rules. Instead, the mistakes resulted from an organizational environment that normalized (through a vigorous and often contentious working group process) deviations from known safety standards to the point that deviation became the accepted norm. The NASA engineers thought that what they were doing was safe.

Because the work environment can have such a powerful influence on employees' basic sense of right and wrong, company leadership should think hard about how to shape that work environment. How many employees know there is an internal whistle-blower hotline and how to find the number? Do they know there is a compliance officer and who that person is? Do they feel from their peers, manager, and company leadership that doing business ethically and within the bounds of the law is of equal or higher priority than generating higher earnings? Are employees kept abreast of legal and regulatory changes that affect their business decisions? Is the company code of conduct enforced?

5. Get Compliance Help When Needed

Managing the increased complexity of a growing company requires a range of new skill sets that founders do not necessarily have, including implementing a compliance program. Although we recognize the challenges in making the case to upper management that resources should be devoted to improving compliance, especially when a company is in its early stages, that case can and should be made. The risks of letting compliance efforts lag and a compliance gap go unaddressed—many of which we have described above—can be catastrophic to the company, its leadership and its employees.

For handling compliance issues after they come to light, first determine whether the company can handle the internal investigation in-house. Basic factors to consider are: the scope of the issues, the seriousness of the potential violation, personnel availability and skill sets, the seniority of those potentially implicated, the likelihood the company will voluntarily report the investigation to regulators, and the need for neutral and impartial investigators.

If the company cannot handle the investigation in-house, hire with care. You want investigators with experience navigating regulatory inquiries and credibility with regulators because a shallow or poorly handled investigation may be worse than none at all. Both the DOJ and SEC have recently offered searing criticism of ''superficial'' internal investigations.[19] Because these regulators decide whether to pursue a case against the company, and since they lack resources to perform investigations on their own in most instances, the name of the game in any internal investigation is establishing and maintaining credibility with the regulators. This requires identifying the proper scope of the investigation, conducting it thoroughly and with integrity, and effectively communicating with regulators about the investigation's progress and results.

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[18] *Id.* at 408.

[19] Jessica Nall and Janice Reicher, *Achieving Credibility in Internal Investigations: Getting Inside the Enforcer's Mind*, The Champion 24 (June 2013).