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Compliance in cross-border Corporate Groups

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Introduction

“ Compliance is everything”¹.

Thomas Friedman

* * *

0. As corporate compliance has become an integral part of both the legal and the policy discourse, this research sets out to examine some of the key questions posed by compliance to contemporary corporate governance. The dominant question surrounding compliance in cross-border corporate groups concerns the concentration of duties within a group holding company against the backdrop of regulatory diversity, increased private-to-private compliance obligations and growing attention to risk management.

1. The research draws on a wide body of literature (books, policy elements, peer-reviewed articles, grey literature, press reports, internet based materials) dealing with a variety of compliance-related topics such as the nature of the duties associated to compliance, its implications for corporate governance in the context of corporate groups active in different jurisdictions and the interplay with risk management regulations. This thesis provides multiple and

¹Friedman, T. L. (2005). *The world is flat: A brief history of the twenty-first century*. New York: Farrar, Straus and Giroux.

converging evidence that the challenges of compliance within a cross-border group cannot be solved by relying exclusively on a “one-size-fits-all” process as a means for staying compliant with their foreign obligations throughout the world. While an accurate assessment of compliance organizations’ recognition in alien jurisdictions will only be possible once a robust bulk of case law and policy developments become available, this thesis acknowledges that the job of group compliance officer may indeed prove a Sisyphean task but there are several limitations imposed on his role which should be duly taken into account. More specifically, this thesis specifically aims to advance research in the area of corporate compliance by addressing the complexity associated with recognition of compliance organizations, corporate programs and processes adopted in foreign jurisdictions, and the uncertainties which surround the role and liability of board members and compliance officers.

2. A fundamental and controversial preliminary question examined in Part I of this research is whether “corporate compliance” is a novel concept *an sich* to which actual legal and policy consequences can be connected, and, if so, which ones and to what extent. Over the last 10 years, compliance has become a fashionable topic across Europe. Yet, for all its fashion, the very expression “compliance” is not entirely clear in its contours, contents and implications. Several factors arguably concurred to determine this lack of clarity and indefiniteness. Firstly, the term “compliance” was often left untranslated, so that it is called “corporate compliance” (or simply “compliance”) in languages other than English. Moreover, the terms “corporate compliance” and “compliance” are often used interchangeably, though this research provides

evidence that “corporate compliance” seems to put more emphasis on the aspects of the **legal configuration of the organisational structure** and represents reciprocation to the obligations of “corporate governance”². Secondly, compliance is mentioned in the media frequently but it is rarely analysed as a comprehensive legal and policy issue. As a scholar put it: “*In der Oeffentlichkeit kam die schnelle Verurteilung!*”³ (Translation: “The quick judgement was made in the media spotlight!”). Little attention is paid to legal criteria and categories at all, and no distinction is for instance made between *good practice* (soft law) on one hand, and *law prescriptions* (hard law) on the other hand. In addition, it is usually not asked whether cross-border compliance on a large scale represents a new international policy pattern.

3. At the outset of this research, it is also necessary to clarify that compliance is different from “corporate social responsibility”, which has an even wider scope and effect⁴. In fact, the latter term covers the moral, social and ethical behaviour standards maintained by the company by means of the establishment of in-house guidelines and codes of conduct. Corporate social responsibility is routinely not considered a legal duty – unless it is explicitly embedded in a legal obligation – but merely a combination of in-house

² Casper, M. (2012). Corporate Governance and Corporate Compliance. In Du Plessis, J.J., Großfeld, B., Luttermann, C., Saenger, I., Sandrock, O., & Casper, M. (Eds.), *German Corporate Governance. International and European Context*. Berlin-Heidelberg: Springer, 358-397.

³ Schneider, U.H. (December 8, 2009). Compliance im Konzern, *NZG - Neue Zeitschrift für Gesellschaftsrecht*, 34, 1321.

⁴ Lampert, T. (2010). *Corporate Compliance – Handbuch der Haftungsvermeidung im Unternehmen*. München: CH Beck Verlag, S9,20.

requirements with which the company aims to comply, often to benefit from a marketing point of view. Yet, according to several scholars⁵, it is becoming increasingly difficult to separate compliance from corporate social responsibility. Moreover, some legal definitions, such as the one provided under Article 4.1.3 of the German Corporate Governance Codex (GCGC)⁶ also seems to include the concept of corporate social responsibility under compliance⁷ insofar as it not only stipulates obedience to the law but also includes aspirational goals. The Basel Committee seems to semantically include elements of corporate social responsibility within compliance policy: “[...] a bank’s compliance policy will not be effective unless the board of directors promotes the values of honesty and integrity throughout the organisation. Compliance with applicable laws, rules and standards should be viewed as an essential means to this end”⁸. Also the newly released ISO 19600 standard⁹ on compliance management systems states that: “an organization’s approach to compliance is ideally shaped by the leadership applying core values and generally accepted corporate governance, ethical

⁵ Wolframm, S. (2008). *Die ethische Dimension der Compliance*. München-Ravensburg: GRIN Verlag, 6.

⁶ “The Management Board ensures that all provisions of law and the company’s internal policies are abided by and works to achieve their compliance by group companies (compliance)”.

⁷ Casper, M. (2012). Corporate Governance and Corporate Compliance. In Du Plessis, J.J., Großfeld, B., Luttermann, C., Saenger, I., Sandrock, O., & Casper, M. (Eds.), *German Corporate Governance. International and European Context*. Berlin-Heidelberg: Springer, 358-397.

⁸ <http://www.bis.org/publ/bcbs113.pdf>.

⁹ ISO (the International Organization for Standardization) is a worldwide federation of national standards bodies (ISO member bodies). The work of preparing International Standards is normally carried out through ISO technical committees. Each member body interested in a subject for which a technical committee has been established has the right to be represented on that committee. International organizations, governmental and non-governmental, in liaison with ISO, also take part in the work.

and community standards. Embedding compliance in the behaviour of the people working for an organization depends above all on leadership at all levels and clear values of an organization, as well as an acknowledgement and implementation of measures to promote compliant behaviour. If this is not the case at all levels of an organization, there is a risk of noncompliance". ISO's position is also that: "organizations are increasingly convinced that by applying binding values and appropriate compliance management, they can safeguard their integrity and avoid or minimize noncompliance with the law. Integrity and effective compliance are therefore key elements of good, diligent management. Compliance also contributes to the socially responsible behaviour of organizations". It is thus fair to say that it is often difficult to draw the line that separates compliance from corporate social responsibility, and this is largely due to the fact that compliance duties exist (both general ones and substantive ones) but they come in open-ended form and provide significant flexibility as to how compliance should be organized by a company or a corporate group.

4. Another key aspect in the global discourse about compliance concerns its relation with the increasingly dominant risk culture, and with the spreading of risk management as a key component of contemporary managerial best practice and legal culture. Quite tellingly, the ISO 19600 guideline about compliance management systems also follows a risk-based approach: after establishing the context in which it operates, the organization must perform a "compliance risk assessment". The identified risks (compliance obligations) are the basis for establishing and implementing controls. The performance of those risk treatment measures must then be evaluated and improved upon, as well as

communicated both internally and externally. One can even go so far as to say that compliance requires risk management¹⁰ but is in turn part of it¹¹. What seems to be contradictory is actually quite logical: in order to conduct successful compliance management key compliance risks¹² have to be selected and dealt with.

5. Lastly, it is important to preliminarily point out that within the vast body of literature about compliance, many different perceptions of the ultimate *purpose* of compliance and about the role of boardrooms and compliance officers can be found. More specifically, corporations and their leaders embody a role that is seen as shifting between the role of a *sheriff* or draconian enforcer, and the role of a *teacher/educator*¹³. As a scholar put it: *“nach der einen Ansicht entspricht Compliance der Taetigkeit einer Polizeibehoerde. Sie hat repressive Funktionen. [...] Nach einer zweiten Ansicht nimmt Compliance die Aufgaben einer Schulbehoerde wahr. Ihre Aufgabe lautet: informieren und kontrollieren”*¹⁴ (translation: “from one angle, compliance corresponds to the activity of a police institution, with repressive functions [...] from another angle, the tasks of

¹⁰ Hauschka, C. E. (2007). *Corporate Compliance – Handbuch der Haftungsvermeidung im Unternehmen*, München: CH Beck Verlag, 3.

¹¹ Hauschka, C. E. (2007). *Corporate Compliance – Handbuch der Haftungsvermeidung im Unternehmen*, München: CH Beck Verlag, 11.

¹²According to ISO 19600 par. 3.1.2 definition, compliance risk is *“the effect of uncertainty on compliance objectives”*, and it *“can be characterized by the likelihood of occurrence and the consequences of noncompliance with an organization’s compliance obligations”*.

¹³Weber, J., & Fortun, D. (2005). Ethics and compliance officer profile: Survey, comparison, and recommendations. *Business and Society Review*, 110(2), 97-115.

¹⁴Schneider, U.H. (December 8, 2009). Compliance im Konzern. *NZG - Neue Zeitschrift für Gesellschaftsrecht*, 34, 1325.

compliance bear resemblance to those of a school/educational institution, whose role is to inform and control”). According to the Basel Committee on Banking Supervision, for instance, one of the functions of the compliance function is “to assist senior management in educating staff on compliance issues”¹⁵, “acting as a contact point within the bank for compliance queries from staff members”, “establishing written guidance to staff on the appropriate implementation of compliance laws, rules and standards through policies and procedures and other documents such as compliance manuals, internal codes of conduct and practice guidelines”¹⁶. In our research, we will among other things show how important civil society, combined with “enforced self-regulation”, can be in modelling the contours of compliance’s contents.

6. With this background in mind, this research is organized in three main parts:

¹⁵Par. 7.2.2 of the ISO 19600 standard (“Training”) clarifies that “the governing body, management and all employees have compliance obligations should be competent to discharge these effectively. The attainment of competence can be achieved in many ways, including skills and knowledge required through education, training or work experience. The objective of a training program is to ensure that all employees are competent to fulfil their job role in a manner that is consistent with the organization’s compliance culture and its commitment to compliance. Properly designed and executed training can provide an effective way for employees to communicate previously unidentified compliance risks. Education and training of employees should be: a) tailored to the obligations and compliance risks related to the roles and responsibilities of the employee; b) where appropriate, based on an assessment of gaps in employee knowledge and competence; c) undertaken at commencement with the organization and be on-going ; d) aligned to the corporate training program and be incorporated into annual training plans; e) practical and readily understood by employees; f) relevant to the day-to-day work of employees and illustrative of the industry, organization or sector concerned; g) sufficiently flexible to account for a range of techniques to accommodate the differing needs of organizations and employees”.

¹⁶Available online at: <http://www.bis.org/publ/bcbs113.pdf>.

- i.** in part I, “compliance” duties are examined in the context of a single, stand-alone company. The primary research goal of this part is to investigate the very existence and the contours of the “duty of compliance”. In particular, the duty of compliance is examined both within the context of a wider management duty in general law, and with a view to specific legal obligations such as those set forth under Mifid. Furthermore, the contents of the compliance duty and its implications for corporate governance are explored. In particular, the organizational obligation (e.g. the duty to establish a compliance department within a company) embedded in the compliance duty is discussed and analysed against the backdrop of existing civil and criminal law developments as well as key case law. The organizational aspects stemming from compliance are also taken into account, and processes to foster internal communication of potential violations within a company such as whistleblowing are described also with a view to potential conflicts with data protection laws. Finally, the allocation of compliance-related roles across management board, supervisory board and compliance department is pointed out, and reference is made to the role and specific liability of the compliance officer;
- ii.** in part II, compliance duties are considered within the wider context of a corporate group, and in particular the trade-off between the compliance obligation of group subsidiaries, and the duty of the parent company is examined. Attention is devoted to one-enterprise schemes and judgements where the existence of a “group interest” that extends

beyond the interest of individual companies is detected. From the point of view of organization, the key distinction between centralized group-wide compliance and decentralized compliance is examined. In the former model, a single compliance organization of the parent company oversees compliance for the whole group. In the latter model, the parent's compliance organization usually sets general guidelines, but specific compliance management is dealt with by the subsidiaries' compliance organizations. It is noted that within a centralized model the compliance officers of the parent company can be characterized as "external consultants" rendering their services to group subsidiaries, and that in many jurisdictions attorney-client privileges may be entailed, too. Specific limitations to compliance duties are pointed out in the context of a corporate group, and the case is made that the role of compliance officer of a cross-border corporate group is indeed a Sisyphian task, but also that substantial restraints are imposed on him/her by other legal obligations, regulatory diversity, complexity of organizations, the legal status of compliance officer;

- iii. in part III, the argument is upheld that compliance duties represent not just a legal novelty per se, but also a trend and an international *policy novelty* that entails "enforced self-regulation" by corporate actors and increased collaboration with state authorities as well as the inclusion of compliance obligations which are not just statements of principles, but prescriptions about processes in private-to-private contractual arrangements. Among the factors contributing to the rise of compliance

as a global phenomenon, the tendency to blend risk management and legal obligations is examined – and so are the downsides of this tendency.

Part I

Compliance in the single company

“ [the board has]a duty to attempt in good faith to assure that a corporation’s information and reporting system, which the board concludes is adequate, exists, and that failure to do so under some circumstances may, in theory at least, render a director liable for losses caused by noncompliance with applicable legal standards.”.

*In re Caremark International Inc. Derivative Litigation*¹⁷

* * *

Chapter 1: Compliance as a Management Task

0. One of the first elements to address for the purposes of this research is whether “compliance” is (only) about *good practice*¹⁸ or whether it (also) entails **binding legal duties**. In this respect, as a scholar put it¹⁹, it is a *Binseweisheit* (truism) that corporate boards have to adhere to the law (in German: “*an Recht und Gesetz*”) when managing the company. In fact, it goes without saying that a

¹⁷698 A.2d 959 (Del. Ch. 1996).

¹⁸Goncharov, I., Werner, J. R., & Zimmermann, J. (2006). Does compliance with the German corporate governance code have an impact on stock valuation? An empirical analysis. *Corporate Governance: An International Review*, 14(5), 432-445.

¹⁹Schneider, U.H. (December 8, 2009). Compliance im Konzern. *NZG - Neue Zeitschrift für Gesellschaftsrecht*, 34, 1322.

board has to adhere to the law and to good management principles²⁰. In Germany, for instance, there is agreement that the management board of an AG has a duty of legality (“*Legalitätspflicht*”), and the same duty applies to an Italian *Società per Azioni*’s board insofar as it must comply with the applicable law when managing and directing the business of the corporation²¹. **It is therefore clear from the very beginning that compliance is not (only) a good practice.** This duty does not only cover compliance with the law and the articles of incorporation by the management board itself, hence in the following paragraphs it will be examined what is entailed by this duty.

1. Having acknowledged that the duty of legality is a basic requirement of the boardroom, it is also necessary to recall that the duty of legality typically includes an **organisational duty**²² to manage the company in such a way that compliance with the statutory provisions as well as the articles of incorporation is secured at all subsidiary levels, i.e. all operative departments of the whole company. This is particularly evident for legal obligations which are binding for the company and/or for the directors. In particular, reference should be made to a variety of legal areas, starting from antitrust/competition law,

²⁰Falk, M. (2012). Governance und Compliance-Begriff und Bezugsrahmen. *IT-Compliance in der Corporate Governance*. Wiesbaden: Gabler Verlag, 27-45.

²¹Frischemeier, A. (2014). *Die Haftung geschäftsführender Organe für Compliance-Verstöße in Tochtergesellschaften*. Pieterlen-Bern: Peter Lang Verlag.

²²Verse, D. A. (2011). Compliance im Konzern, Zur Legalitätskontrollpflicht der Geschäftsleiter einer Konzernobergesellschaft. *ZHR - Zeitschrift für das gesamte handelsrecht und wirtschaftsrecht*, 175(2), 401-424.

corporate law, etc..²³Therefore, in Germany some speak of a duty to monitor legality (“*Legalitätskontrollpflicht*”)²⁴ or monitoring duty. According to Fleischer²⁵, the monitoring duty can present itself with a *gradient* of intensity, as the monitoring duty can be more or less intensive depending on a number of elements, including the following ones:

- ✓ **Clues/suspect elements** (“*Verdachtsmomenten*”): directors must act without immediately if they detect signs of potential breaches or unlawful behaviour by company employees. The duty, thus, arises when actual elements for suspicion (“*greifbare Anhaltspunkte*”) arise, and board directors must take action immediately.
- ✓ **Ongoing control** (“*Laufende Kontrolle*”). As part of the duty to monitor, the board must engage in ongoing controls, and not just step in “*ex post*”, when a suspicion arises and the benefit of hindsight is available.
- ✓ **Precedents**: if the company’s track record includes precedents of breaches or mis-compliance, this should result into heightened monitoring by the board, and in its organization.
- ✓ **Commensurate organization**: the size and scope of monitoring duties should be commensurate with the size, type, complexity of the business

²³Schneider, U.H., & Schneider, S.H. (2007). Konzern-Compliance als Aufgabe der Konzernleitung. *ZIP – Zeitschrift für Wirtschaftsrecht*, 44, 2061-2065.

²⁴Verse, D. A. (2011). Compliance im Konzern, Zur Legalitätskontrollpflicht der Geschäftsleiter einer Konzernobergesellschaft. *ZHR - Zeitschrift für das gesamte handelsrecht und wirtschaftsrecht*, 175(2), 401-403.

²⁵Fleischer, H. (2008). Corporate Compliance im aktienrechtlichen Unternehmensverbund. *CCZ - Corporate Compliance Zeitschrift*, 1(1), 1-6.

conducted²⁶. The principle of proportionality is very important, and it means that there is no such thing as a default compliance organization, but a variety of different solutions which have to match the actual business of the company and its group. This is for instance reflected in the words of the Basel Committee on Banking Supervision on bank compliance: *“Regardless of how the compliance function is organised within a bank, it should be independent and sufficiently resourced, its responsibilities should be clearly specified, and its activities should be subject to periodic and independent review by the internal audit function. [...] The principles should be applicable to all banks, although it is for individual banks to determine how best they should be implemented. A bank may be able to follow practices other than those set out in this paper which are also sound and which, taken together, demonstrate that its compliance function is effective. The way in which the principles are implemented will depend on factors such as the bank’s size, the nature, complexity and geographical extent of its business, and the legal and regulatory framework within which it operates. In smaller banks, for example, it may not be practicable to implement in full some of the specific measures recommended in this paper, yet the bank may be able to take other measures that achieve the same result”*²⁷.

²⁶Schweikert, C., & Jantz, M. (2012). Corporate Governance in Abhängigkeit von Unternehmensstruktur und Unternehmensgröße-eine betriebswirtschaftlich-juristische Analyse. *Leitlinien für das Management von Organisations-und Aufsichtspflichten*. KICG-Forschungspapiere, No. 3.

²⁷Available online at: <http://www.bis.org/publ/bcbs113.pdf>.

Compliance counts as an indispensable part of the management board's management tasks: *Compliance ist Chefsache*²⁸! Further along these lines, according to the Basel Committee on Banking Supervision April 2005 paper *Compliance and the Compliance function in banks*: "a bank's compliance policy will not be effective unless the board of directors promotes the values of honesty and integrity throughout the organisation. Compliance with applicable laws, rules and standards should be viewed as an essential means to this end. As is the case with other categories of risk, the board is responsible for ensuring that an appropriate policy is in place to manage the bank's compliance risk. The board should oversee the implementation of the policy, including ensuring that compliance issues are resolved effectively and expeditiously by senior management with the assistance of the compliance function"²⁹.

2. Even if the law often grants discretion to corporate boards as to how and to what extent actually implement the organisational duty, this discretion should not be interpreted too broadly: complying or not complying with the laws is in any case not subject to the discretion of the board, and cannot represent an opportunity for cost-opportunity analysis³⁰. In fact, maintaining that the method of compliance is subject to corporate discretion could lead to

²⁸Schneider, U.H. (2003). Compliance als Aufgabe der Unternehmensleitung. *ZIP - Zeitschrift für Wirtschaftsrecht*, 24, 645- 648; Neidhardt, N. (2013). *Compliance Als Chefsache*. München-Ravensburg: GRIN Verlag.

²⁹Available online at: <http://www.bis.org/publ/bcbs113.pdf>.

³⁰Fleischer, H. (2005). Aktienrechtliche Legalitätspflicht und "nützliche" Pflichtverletzungen von Vorstandsmitgliedern. *ZIP - Zeitschrift für Wirtschaftsrecht*, 26, 141-147; Fleischer, H. (2010), Comment of §93. In Spindler, G., & Stilz, E. (Eds.), *Aktiengesetz*. München: CH Beck Verlag.

the assumption that breaches of less serious violations of compliance rules, which can increase profits for the company, are somehow exempt from the the duty of legality. For example, in Germany for a long time there were so-called “useful breaches of duty” (“*nuetzliche Pflichtverletzungen*”)³¹, e.g. the payments of bribes or secret commissions abroad in order to secure lucrative business deals. Frequently, a distinction is made between an **internal** and an **external commitment to duties**³². The internal commitment to duties covers all statutory duties as well as those established by the articles of incorporation, with which the management board has to comply vis-a-vis the company. In particular, these include duties deriving from the Aktiengesetz (German Stock Corporation Act), the articles of incorporation and the employment contracts of management board members. An external commitment to duties exists by means of all other statutory provisions which concern the company as a legal subject (“*Rechtssubjekt*”), which covers foreign rules of law and contractual duties. Compliance with provisions regarding environmental protection serves as a typical example. With regard to the internal commitment to duties, there is agreement that the duty of legality applies without constraints. The external commitment to duties is more difficult to adjudicate. In 1985, the German Federal Court of Justice (Bundesgerichtshof (BGH)) decided³³ that the payment of a secret commission abroad may be immoral, but would not entail a breach of

³¹Grieger, A. (2010). *Corporate Crime und Compliance: die straf-und zivilrechtliche Verantwortlichkeit eines boersennotierten Industriekonzerns und dessen Organe fuer Wirtschaftsdelikte seiner Mitarbeiter*. Hamburg: Diplomica Verlag, Vol. 16.

³² Casper, M. (2012). Corporate Governance and Corporate Compliance. In Du Plessis, J.J., Großfeld, B., Luttermann, C., Saenger, I., Sandrock, O., & Casper, M. (Eds.), *German Corporate Governance. International and European Context*. Berlin - Heidelberg: Springer, 365.

³³BGH, May 8, 1985.

duty of the acting management board in relation to the company (as legal person), insofar as the payment of the secret commission was in accordance with the local custom in the respective third country. This approach is no longer acceptable because German law has long aligned to intensified OECD-Standards, nor would the case be reflecting nowadays law.

3. When discussing the factors driving the debate on the establishment of compliance systems or “departments”, it is important to stress the importance of **corporate liability**. In several jurisdictions, no specific discipline existed that ascribes criminal responsibility not just to individuals but to legal entities in whose interest a crime was committed³⁴. The development of corporate liability regulations arguably represents a key factor behind the development of compliance departments. This is because corporate liability regulations usually foresee sanctions’ mitigations if compliance programmes exist and are effectively implemented by the company. Italy was one of the last countries³⁵ that introduced a discipline about criminal enterprise liability in 2001. Other countries already foresaw³⁶ forms of enterprise liability for crimes committed

³⁴Geis, G., & DiMento, J. (1995). Should we prosecute Corporations and/or Individuals? In Pearce F., & Snider, L. (Eds.), *Corporate Crime: Contemporary Debates*. Toronto: University of Toronto Press, 72-90.

³⁵Armone, G. (2007). La responsabilità penale delle persone giuridiche nella prospettiva dell’Unione Europea. *La responsabilità amministrativa delle società e degli enti*, 1, 7.

³⁶ The United Kingdom eventually institutionalized enterprise liability with the 1978 “Interpretation Act”, the Netherlands introduced enterprise liability under art. 51 of the Dutch criminal law back in 1979, and France 1994 under art. 121-2 of the criminal law code.

by individuals³⁷. The US, which condensed this approach into the Sarbanes Oxley Act, were already at a very advanced stage of reflection, as the milestone case *New York Central & Hudson River Railroad Co. v. U.S.*³⁸ of 1909 shows. In this case, the Defendant corporation, New York Central & Hudson River Railroad Co. (Defendant), together with a managing agent within the corporation, were convicted of violating a federal law prohibiting the payment of rebates³⁹. Specifically, the corporation was prosecuted for the payment of rebates to the American Sugar Refining Company arising out of shipments of sugar from New York to Detroit. The Defendant was prosecuted under the “Elkins Act”, 32 Stat. 847, which held a corporation criminally liable for unlawful acts of its agents. This important case took away the immunity from criminal prosecution that corporations previously enjoyed⁴⁰. The court’s reasoning was that inasmuch as the corporation could be imputed with the knowledge of the actions its employees were taking in the course of their employment, any criminal culpability for those actions – should they be in violation of law – could also be imputed to the corporation. Prosecutors need not show that the board, or even senior officers, encouraged or were complicit

³⁷ Khanna, V.S. (2000). Corporate Liability Standards: When Should Corporations Be Held Criminally Liable?. *AM. CRIM. L. REV - American Criminal Law Review*, 37, 1239, 1271-1272.

³⁸ *New York Central & Hudson River Railroad Co. v. U.S.*, 22 Ill.212 U.S. 481, 29 S. Ct. 304, 53 L. Ed. 613 (1909).

³⁹ DiMento, J.F.C., & Geis, G. (2005). Corporate criminal liability in the United States. In Tully, S. (Ed.), *Research Handbook on Corporate Legal Responsibility*. Cheltenham: Edward Elgar Publishing Limited, 159; Brickey, K. F. (1982). Corporate criminal accountability: A brief history and an observation. *Washington ULQ - University Law Quarterly*, 60, 393. Available at:

http://openscholarship.wustl.edu/cgi/viewcontent.cgi?article=2261&context=law_lawreview.

⁴⁰ Wormser, M. (1912). Piercing the veil of corporate entity. *Columbia Law Review*, 12, 496.

in the crime. Thus, in order to deter criminal charges, managers must ensure that adequate information systems are in place and implement “policing measures” that increase the likelihood that the government detects and sanctions wrongdoers⁴¹. These measures include adopting effective compliance programs truly designed to detect wrongdoing and identify violators, promptly reporting wrongdoing to the government, and cooperating with any government investigation. Although effective enforcement of the criminal law depends on encouraging corporations to detect and report wrongdoing, until recently most laws did not encourage companies to do so⁴².

4. As will be described more in-depth infra (Chapter 2, par. 9), on the one hand it is evident that there is such as thing as a duty of legality, and that the duty of legality includes an organizational duty as well. On the other hand, it is far less evident that this organizational duty entails the establishment of a corporate compliance department, i.e. an institution within the company. Some authors such as Schneider, based on a general analogy with substantive duties, believe that the duty of organization contains such as an obligation – a general obligation - as well. Since the existence of a *general* obligation to set up a corporate compliance department is not explicit, some guidance can be found in risk management provisions. After all, as we have pointed out in our research’ introduction, one can go so far as to say that compliance requires risk

⁴¹Gray, G. C. (2006). The Regulation of Corporate Violations, Punishment, Compliance, and the Blurring of Responsibility. *British Journal of Criminology*, 46.5, 875-892.

⁴²Ribstein, L. E. (2002). Market vs. regulatory responses to corporate fraud: A critique of the Sarbanes-Oxley Act of 2002. *J. Corp. L. - Journal of Corporation Law*, 28, 1.

management⁴³ but is in turn part of it⁴⁴. What seems to be contradictory is actually quite logical: in order to conduct successful compliance management key compliance risks have to be selected and dealt with. Substantive provisions on risk management and internal control are few. In 1998, for instance, the German Parliament enacted the Control and Transparency in Business Act (KonTraG) under which it was provided that **the management board must establish an early risk recognition system**. The system must provide assurance that material risks that can endanger the going concern of the company or, according to the German literature, can impair the net worth, financial position and results of the company in a sustainable manner, are identified. The German law requires a system to be set up, but only to the extent that risks that can cause material damage can be identified at an early stage. The management report must also report on the risks of the future development of the company⁴⁵. Moreover, auditors must control the risk early recognition system.

5. Also other European countries have foreseen “early risk detection” systems without going into specifics as to how the systems should be designed. For instance in 2010 the Danish Companies act was modernized, and it is provided that the board of directors, or in case the company has opted for a two-tier board structure, the supervisory board, must ensure that “adequate

⁴³ Hauschka, C. E. (2007). *Corporate Compliance – Handbuch der Haftungsvermeidung im Unternehmen*, München: CH Beck Verlag, 3.

⁴⁴ Hauschka, C. E. (2007). *Corporate Compliance. Handbuch der Haftungsvermeidung im Unternehmen*, 11.

⁴⁵By analogy, also art. 2428 of the Italian civil code foresees extensive risk disclosure in the management report.

risk management and internal control procedures have been established”⁴⁶. The Danish law does not provide any additional guidance to companies as to what is considered an “adequate” system. The Danish corporate governance code which was amended in 2011 to integrate the new Companies Act only recommends an annual identification of the most important business risks as well as communication between the executive and the supervisory boards of the most important areas of risk and compliance including the adopted policies, frameworks etc. in order to enable the supervisory board to assess the development and make the necessary decisions. The Danish act also provides indirectly for a similar early risk recognition system as the German act⁴⁷.

6. The UK Companies Act 2006 requires the director to consider inter alia the likely consequences of any decision in the long term and the impact of the company’s operations on the community and the environment. However, boards of listed companies must comply with more stringent internal control provisions. The UK Listing Rules compel companies to apply the Main Principles of the UK Corporate Governance Code and report to shareholders on how they have done so. Main principle C 2 makes the board responsible “for determining the nature and extent of the significant risks it is willing to take in achieving its strategic objectives. The board should maintain **sound risk management and internal control systems**”. The Financial Reporting Council’s

⁴⁶Aven, T., & Renn, O. (2010). *Risk management and governance: concepts, guidelines and applications*. New York: Springer.

⁴⁷Van der Elst, C. (2013). The Risk Management Duties of the Board of Directors. *Financial Law Institute, Working Paper, S2013-02*. Available at SSRN: <http://ssrn.com/abstract=2267502>.

Internal Control Guidance for Directors on the Combined Code provides in details what it considers a “sound” system:

“An internal control system encompasses the policies, processes, tasks, behaviours and other aspects of a company that, taken together:

- facilitate its effective and efficient operation by enabling it to respond appropriately to significant business, operational, financial, compliance and other risks to achieving the company's objectives. This includes the safeguarding of assets from inappropriate use or from loss and fraud and ensuring that liabilities are identified and managed;*
- help ensure the quality of internal and external reporting. [...];*
- help ensure compliance with applicable laws and regulations, and also with internal policies with respect to the conduct of business.*

A company's system of internal control will reflect its control environment which encompasses its organizational structure. The system will include:

- control activities;*
- information and communication processes; and*
- processes for monitoring the continuing effectiveness of the system of internal control.*

The system of internal control should:

- be embedded in the operations of the company and form part of its culture; [...].”*

Other countries only indirectly force the establishment of an internal control or risk management system. France is an example of this approach. The French

Commercial Code requires the board of directors to perform all controls and verifications that it considers expedient⁴⁸. In Italy there is no general duty foreseen by the Civil Code to establish an internal control department – there is however, a duty to ensure an “adequate organization”. Specific requirements are foreseen by industry-specific or business-specific regulation. Perhaps more importantly, many corporate players are deliberately opting for establishing an *ad hoc* compliance department and effectively implement its programme and guidelines in order to benefit from corporate liability as foreseen under D. Lgs. no. 231/2001⁴⁹.

Chapter 2: Compliance as a Duty to Establish a Compliance Department?

7. So far, it has already been clarified that many Western corporate governance laws entail a general duty for corporate boards to ensure organizational adequateness within the company. We have also pointed out that in many cases the creation of burdensome compliance departments, programs and guidelines is the consequence of legal incentives, such as in Italy the exemption from corporate liability regime pursuant to D. Lgs. no. 231/2001. Paragraphs 7 and 8 examine the incentives deriving from corporate liability insulation, while paragraph 9 deals with the question of whether, in the absence

⁴⁸Van der Elst, C. (2013). The Risk Management Duties of the Board of Directors. *Financial Law Institute, Working Paper, S2013-02*. Available at SSRN: <http://ssrn.com/abstract=2267502>.

⁴⁹Paludi, A., & Zecca, M. (2014). Corporate Responsibility and Compliance Programs in Italian Case Law. In Manacorda, S., Centonze, F., & Forti, G. (Eds.), *Preventing Corporate Corruption*. Springer International Publishing A.G., 397-416.

of this type of incentives, the general organizational adequateness duty actually includes the creation of totally comprehensive systems of compliance and control⁵⁰. The recognition of an extensive duty of legality does not automatically mean that the management board has to establish a totally comprehensive system of compliance-control in the company. In this respect, one must also make a key distinction between the **duty** of legality and what is a **choice** dictated by opportunity. More specifically, on one hand for most jurisdictions **the management board is not an assistant public prosecutor** (“*Hilfsbeamter der Staatsanwaltschaft*”)⁵¹. On the other hand, in order to induce companies to monitor, report, and cooperate, it is fair to assume that boards expect to be better off if they engage in policing measures than if they do not⁵². This implies that they must be confident of facing lower expected liability if they monitor, investigate, and report. This promise of insulation from criminal sanctions grants a substantial benefit to corporations that⁵³ adopt compliance organizations and programs to deter crime, respond proactively to reports of suspected wrongdoing, and cooperate fully with any government investigation. To benefit from this legal attitude, boards faced with evidence of potential of wrongdoing must avoid the temptation to circle the wagons in an effort to thwart unwanted government intrusion – particularly when evidence suggests managers may indeed have committed a crime. Instead they must focus on

⁵⁰In other words: is there a *general duty* to establish a compliance department?

⁵¹Siebler, B. (2014). *Criminal-Compliance im interdisziplinären Kontext: Die Legitimierung von Compliance-Tätigkeiten und Maßnahmen sowie deren Verwertbarkeit im deutschen Strafoerfahren*. Hamburg: Diplomica Verlag.

⁵²Goldsmith, M., and King, C. (1997). Policing Corporate Crime: The Dilemma of Internal Compliance Programs. *Vanderbilt Law Review*, 50.1.

⁵³ Malloy, T. (2003). Regulation, Compliance and the Finn. *Temple Law Review*, 76, 451-459.

their primary duty: to the firm. This often will place directors in the uncomfortable position of cooperating with investigations that threaten long-term colleagues and friends⁵⁴. Managers who implement effective measures to detect crime and who report wrongdoing can benefit their companies even if prosecutors do decide to indict. For instance, under the **US federal sentencing guidelines** and the Italian D. Lgs. no. 231/2001, a convicted corporation faces a significantly lower criminal fine if it had an effective compliance program, reported wrongdoing promptly, and cooperated than if it did not⁵⁵. For example, if a company can prove that, before the crime was committed, it adopted and effectively implemented a model of organisation, management and control it is exempt from liability under Italian law⁵⁶. Moreover, a corporation whose managers follow good corporate practices in deterring crime may avoid intrusive corporate probation. According to the November 2012 SEC's Enforcement Division's *"Resource Guide to the U.S. Foreign Corrupt Practices Act"*⁵⁷, the following elements represent essential keystones of a compliance model:

- Commitment from Senior Management and a clearly articulated policy against corruption: compliance and ethical rules must start at the top⁵⁸. Prosecutors

⁵⁴Scholz, J.T. (1984). Voluntary compliance and regulatory enforcement. *Law & Policy*, 6.4, 385-404.

⁵⁵de Maglie, C. (2011). *Societas delinquere potest? The Italian solution*. In Mark Pieth, M., & Ivory, R. (Eds.), *Corporate Criminal Liability: Emergence, Convergence, and Risk*. New York: Springer, 9, 255-270.

⁵⁶Articles 6 and 7 of Legislative Decree no. 231/2001.

⁵⁷ Available online at: <http://www.justice.gov/criminal/fraud/fcpa/guide.pdf>.

⁵⁸ According to the ISO 19600 standard (par. 5.3.3): *"the governing body and top management should d) appoint or nominate a compliance function with: 1) authority and responsibility for the*

thus evaluate whether senior management has clearly articulated company standards, communicated them in unambiguous terms, adhered to them scrupulously, and disseminated them throughout the organisation.

-Code of Conduct, Compliance Policies and Procedures: whether a company has policies and procedures that outline responsibilities for compliance within the company, detail proper internal controls, auditing practices, and documentation policies, and set forth disciplinary procedures will also be considered by prosecutors. Effective policies and procedures require an in-depth understanding of the company's business model, including its products and services, third-party agents, customers, government interactions, and industry and geographical risks.

-Oversight, Autonomy, and Resources: a legal person needs an assigned responsibility for the oversight and implementation of a company's compliance programme to one or more specific senior executives. Those individuals must have appropriate authority within the organisation, adequate autonomy⁵⁹ from management, and sufficient resources⁶⁰ to ensure that the company's

design, consistency and integrity of the compliance management system; 2) clear and unambiguous support from and direct access to the governing body and top management; 3) access to: – senior decision-makers and the opportunity to contribute early in the decision-making processes; – all levels of the organization: – all documented information and data needed to perform the compliance tasks; – expert advice on relevant laws, regulations, codes and organizational standards; 4) the authority and capacity to execute countervailing power, by showing any consequences for compliance in relevant decision-making processes”.

⁵⁹According to the ISO 19600 standard (par. 5.3.3), “the governing body and top management should [...]ensure that the compliance function has authority to act independently and is not compromised by conflicting priorities, particularly where compliance is embedded in the business”.

⁶⁰According to the ISO 19600 standard (par. 7), “the organization should determine and provide the resources needed for the establishment, development, implementation, evaluation, maintenance and continual improvement of the compliance management system appropriate to its size,

compliance programme is implemented effectively. Adequate autonomy generally includes direct access to an organisation's governing authority, such as the board of directors and committees of the board of directors (e.g., the audit committee).

- Risk Assessment: one-size-fits-all compliance programmes are generally ill-conceived and ineffective because resources inevitably are spread too thin, with too much focus on low-risk markets and transactions to the detriment of high-risk areas. Factors to consider, for instance, include risks presented by: the country and industry sector, the business opportunity, potential business partners, level of involvement with governments, amount of government regulation and oversight, and exposure to customs and immigration in conducting business affairs. It is decisive whether and to what degree a company analyses and addresses the particular risks it faces⁶¹.

complexity, structure and operations. Top management and all other levels of management should ensure that the necessary resources are deployed effectively to ensure that the compliance management system meets its objectives, and that compliance is achieved. Resources include financial and human resources, as well as access to external advice and specialized skills, organizational infrastructure, contemporary reference material on compliance management and legal obligations, professional development and technology".

⁶¹According to the ISO 19600 standard (par. 9.1.1), "the organization should determine: a) what needs to be monitored and measured and why; b) the methods for monitoring, measurement, analysis and evaluation, as applicable, to ensure valid results; c) when the monitoring and measuring should be performed; d) when the results from monitoring and measurement should be analysed, evaluated and reported. The organization should retain appropriate documented information as evidence of the results. The organization should evaluate the compliance management system performance and the effectiveness of the compliance management system".

- Training and Continuing Advice: such measures will help ensure that the compliance programme is understood and followed appropriately at all levels of the company⁶².
- Incentives and Disciplinary Measures: many companies have found that publicising disciplinary actions internally⁶³, where appropriate under local law, can have an important deterrent effect, demonstrating that unethical and unlawful actions have swift and sure consequences. Incentives can take many forms such as personnel evaluations and promotions, rewards for improving and developing a company's compliance programme, and rewards for ethics and compliance leadership.
- Third-Party Due Diligence and Payments: third parties, including agents, consultants, and distributors, are commonly used to conceal the payment of

⁶² According to par. 7.2.2 of the ISO 19600 standard, *"the governing body, management and all employees have compliance obligations should be competent to discharge these effectively. The attainment of competence can be achieved in many ways, including skills and knowledge required through education, training or work experience. The objective of a training program is to ensure that all employees are competent to fulfil their job role in a manner that is consistent with the organization's compliance culture and its commitment to compliance. Properly designed and executed training can provide an effective way for employees to communicate previously unidentified compliance risks. Education and training of employees should be: a) tailored to the obligations and compliance risks related to the roles and responsibilities of the employee; b) where appropriate, based on an assessment of gaps in employee knowledge and competence; c) undertaken at commencement with the organization and be on-going ; d) aligned to the corporate training program and be incorporated into annual training plans; e) practical and readily understood by employees; f) relevant to the day-to-day work of employees and illustrative of the industry, organization or sector concerned; g) sufficiently flexible to account for a range of techniques to accommodate the differing needs of organizations and employees"*.

⁶³Par. 7.4.4 of the ISO 19600 standard ("Internal communication") reads as follows: *"the organization should adopt appropriate methods of communication to ensure that the compliance message is heard and understood by all employees on an on-going basis. The communication should clearly set out the organization's expectation of employees and those noncompliances that are expected to be escalated and under what circumstances and to whom"*.

bribes to public officials. As part of risk-based due diligence, companies should understand the qualifications and associations of its third-party partners, including its business reputation, and relationship, if any, with foreign officials. Companies should also have an understanding of the role of, and need for, the third party and ensure that the contract terms specifically describe the services to be performed. Additional considerations include payment terms and how those payment terms compare to typical terms in that industry and country. Furthermore, companies should undertake some form of on-going monitoring of third-party relationships.

- Confidential Reporting and Internal Investigation: an effective compliance programme should include a mechanism for an organisation's employees and others to report⁶⁴ suspected or actual misconduct or violations of the company's policies on a confidential basis and without fear of retaliation. Companies may employ, for example, anonymous hotlines or ombudsmen. Reporting needs to be followed-up by effective investigations.

- Continuous Improvement (Periodic Testing and Review): a company's business changes over time, as do the environments in which it operates, the nature of its customers, the laws that govern its actions, and the standards of its industry. In addition, compliance programmes that do not just exist on paper

⁶⁴ In the words of par. 9.1.3 of the ISO 19600 standard, *"the organization should establish, implement, evaluate and maintain procedures for seeking and receiving feedback on its compliance performance from a range of sources, including: employees, e.g. through whistle blowing facilities, helplines, feedback, suggestion boxes; customers, e.g. through a complaints handling system; suppliers; regulators; process control logs and activity records (including both computer and paper based)"*.

but are followed in practice will inevitably uncover compliance weaknesses and require enhancements.

- Mergers and Acquisitions (Pre-Acquisition Due Diligence and Post-Acquisition Integration): for example, an acquiring company should uncover any possible corruption at the company which is being acquired as part of due diligence, ensure that the corruption was voluntarily disclosed to the government, cooperate with the investigation, and promptly incorporate the acquired company into its compliance programme and internal controls.

Adopting a compliance organization may sometimes even be an “**ex post**” **remedy** when a breach has already been detected. In Italy, for instance pursuant to Art. 12, comma 2, lett. b) of Legislative Decree no. 231/2001 sanctions are reduced to one third if, before the first judiciary session, a compliance model adequate to pre-empt breaches such as those detected. Moreover, pursuant to art. 17, lett. b) of Legislative Decree no. 231/2001 no indictment sanctions (e.g. a ban on liaising with public offices) if the company has filled the organizational gaps which caused the tort by adoption and effectively implementing a compliance model adequate to pre-empt breaches such as those detected.

8. By contrast, a convicted corporation that did not have an effective compliance program is likely to have one imposed (and designed) by the authorities⁶⁵. Managers cannot obtain the full benefit of these mitigation provisions if they wait to act until they suspect wrongdoing. The US sentencing

⁶⁵Alfiero, S., & Secinaro, S. (2009). The Implication of Adopting the Compliance Program in Italian Holding Companies. *International Review of Business Research Papers*, 5.4, 448-456.

guidelines only provide full mitigation for reporting and cooperating to firms that had an effective compliance program at the time the crime occurred. (Prosecutors also are more likely to indict companies that did not have a compliance program). Thus, managers who fail to institute a program designed to detect wrongdoing put their firms at much greater risk of criminal sanction even if they report any wrongdoing they detect.

9. With a view to the previous paragraph, the question should be asked whether the management board has **an actual duty**, in the best interests of and for the benefit of the company, **to establish an institution within the company which reveals violations of law and helps to prevent them**. As stated earlier, it is important to distinguish between an actual duty embedded in a non-substantive obligation, and a choice (although one not free from a variety of positive or negative incentives). Moreover, the answer to this question varies depending on the country. In Germany, for example, it is controversial whether such a duty under organisational law exists for all AGs, aside from the special scheme for investment services companies in Section 33(1) cl. 2 No. 1 of the WpHG⁶⁶. Commentators seem in any case to agree that the management board has to implement its duty of legality, but it is disputed whether this entails establishing a compliance department as well. In any case, it is indispensable that compliance function is entrusted to competent, skilled and

⁶⁶ In favour of this Schneider, U.H. (2003). Compliance als Aufgabe der Unternehmensleitung, *ZIP - Zeitschrift für Wirtschaftsrecht*, 24, 645 - 648; Buerkle, J. (2005). Corporate Compliance - Pflicht oder Kuer fuer den Vorstand der AG?, *BB- Betriebs-Berater*, 60, 565- 568.

knowledgeable professionals, whereas it is fairly marginal whether these professionals have a “compliance department” or work in another department (e.g. legal department) but cover compliance⁶⁷. In Germany, some supporters of a general duty to establish a compliance department refer to Section 130 OWiG according to which the **owner of a company acts contrary to public policy if he or she omits to implement the necessary control measures required to prevent breaches of duty by the company, which are punishable by means of a fine or a sentence**. There is, however, a limitation insofar that the rule only refers to necessary control measures, depending on the particular circumstances of the company. In a certain case, like a very complex corporate structure, the requirements may only be achieved with the establishment of a compliance department, yet, this is not compulsory, in particular not for smaller companies.

10. With a view to the above, the **debate is shifting from the duty of legality to the (possible) duty to establish a compliance department**. Interestingly, this seems to echo the famous 1996 *In re Caremark International Inc. Derivative Litigation*⁶⁸ Delaware case. Arguably, Chancellor William Allen’s opinion in *In re Caremark International Inc. Derivative Litigation* remains one of the most complete and detailed explorations of the duty to monitor by a Delaware court⁶⁹. *Caremark* originated from a federal investigation of illegal

⁶⁷Schneider, U.H., & Schneider, S. (2005). Die zwölf goldenen Regeln des Geschäftsführers zur Haftungsvermeidung. *GmbHHR - GmbH-Rundschau*, 1229.

⁶⁸*In re Caremark International Inc. Derivative Litigation*, 698 A.2d 959 (Del. Ch. 1996).

⁶⁹Funk, S. F. (1997). *In re Caremark International Inc. Derivative Litigation: Director Behavior, Shareholder Protection, and Corporate Legal Compliance*. *Del. J. Corp. L. - Delaware Journal of Corporation Law*, 22, 311.

payments made by Caremark International employees to physicians in exchange for patient referrals. Eventually, Caremark paid out approximately \$250 million to settle the charges. Chancellor Allen had to decide whether the company's directors breached its duty to monitor by allowing these violations to occur. Chancellor Allen concluded that the board of directors cannot assume that the corporation is operating in compliance with the law; instead, it has an actual obligation to invest in monitoring systems that are suitable to identify legal violations. More specifically, in the words of Chancellor Allen, a board has "a duty to attempt in good faith⁷⁰ to assure that a corporation's information and reporting system, which the board concludes is adequate, exists, and that failure to do so under some circumstances may, in theory at least, render a director liable for losses caused by noncompliance with applicable legal standards." However, under the standard formulated in Allen's decision, finding a violation of this duty is far from easy⁷¹ as directors must have failed to provide reasonable oversight in a "sustained or systematic" fashion⁷², and the information reporting system on which the board relied⁷³ must have been an "utter failure"⁷⁴. Actual failure to prevent wrongdoing does not in itself mean that the system is an utter failure:

⁷⁰Sale, H.A. (2007). Monitoring Caremark's Good Faith. *Del. J. Corp. L. - Delaware Journal of Corporation Law*, 32, 719.

⁷¹Elson, C.M., and Gyves, C.J. (2004). In Re Caremark: Good Intentions, Unintended Consequences. *Wake Forest L. Rev.- Wake Forest Law Review*, 339, 691.

⁷²Burch, R.F. (2006). Director Oversight and Monitoring: The Standard of Care and the Standard of Liability Post-Enron. *Wyo. L. Rev. - Wyoming Law Review*, 6, 481.

⁷³Grossman, N. (2007). Director Compliance with Elusive Fiduciary Duties in a Climate of Corporate Governance Reform. *Fordham J. Corp. & Fin. L.-Fordham Journal of Corporate & Financial Law*, 12, 393.

⁷⁴Bainbridge, S. (2009). Caremark and Enterprise Risk Management. *UCLA School of Law, Law-Econ Research Paper*, paper no. 09-08.

in fact, a court must also consider the design of the system and make a case-by-case assessment of its effectiveness. And in fact, in *Caremark*, the company, Caremark International had a structured organization in place to ensure compliance with the law. More specifically, Caremark International had regularly run training programs and distributed ethics instructions and checklists to its employees. The board also had reviewed the company's legal compliance systems even after outside auditors found no material weaknesses in the systems. Therefore, based on these elements, Chancellor Allen concluded that the board had made a good faith attempt to ensure compliance with the law. Therefore, it fair to say that the Caremark case is important because of the *principles* stated by Chancellor Allen, which epitomized a change in legal thought occurred over the course of thirty years. In fact, in *Caremark*, the burden on boards to put into place information reporting systems⁷⁵ went beyond what originally contemplated in 1963's *Graham*, raising the question whether the Chancery Court was deliberately ignoring the earlier Delaware Supreme Court decision. Not only did Chancellor Allen not ignore *Graham's* verdict, but he openly questioned whether in 1996 the Delaware Supreme Court still would believe that boards could justify an outdated *laissez-passer* approach⁷⁶, i.e. not making any effort to ensure they collected information "respecting material acts,

⁷⁵Frankel, T. (2008). Corporate Boards of Directors: Advisors or Supervisors. *U. Cin. L. Rev.-University of Cincinnati Law Review*, 77, 501.

⁷⁶Reese, C. L., & Herring, K.A. (2004). Recent Developments in Delaware Case Law: Recent Developments in Delaware Corporate Law. *Del. L. Rev. - Delaware Law Review*, 7, 177-213.

events or conditions within the corporation, including compliance with applicable statutes and regulation[.]”⁷⁷.

Chapter 3: Compliance and foreign criminal laws

11. Another useful element that can be taken into account when assessing the *general* obligation to set up a compliance department is the 2007 UK Corporate Manslaughter and Corporate Homicide Act. Art. 1, par. 3 of the Corporate Manslaughter and Corporate Homicide Act reads as follows:

“An organisation is guilty of an offence under this section only if the way in which its activities are managed or organised by its senior management is a substantial element in the breach referred to [...].”

The wording of the text clearly signals the willingness not to use the role of corporate officers as attribution criterion⁷⁸. It also signals that a different criterion is adopted, namely the fact that the corporate activities can substantially contribute to a crime. Following this approach, an objective factor is used in lieu of arguments based on the alleged role of individuals within their

⁷⁷Allen, Chancellor W. T. (1997). Tribute to Chancellor William T. Allen: Ambiguity in Corporation Law. *Del. J. Corp. L.- Delaware Journal of Corporate Law*, 22 (1997), 894-1337.

⁷⁸Parsons, S. (2003). Doctrine of Identification, Causation and Corporate Liability for Manslaughter. *J. Crim. L.- Journal of Criminal Law*, 67 – 69.

organization⁷⁹. One should not underestimate the relevance of the criterion entailed by Manslaughter, because it may be used to prosecute corporate actors who do not even have a branch office or personnel in the United Kingdom⁸⁰. **Because Manslaughter uses an approach that requires an evaluation of an organization's management and organization⁸¹, this is likely to increase compliance within corporate groups which do business with the United Kingdom⁸².** Moreover, since no specific degree of compliance is put forward, corporate actors are incentivized to adopt the highest level of compliance to pass the scrutiny of British prosecutors⁸³. This is very important, as the architecture of the British Manslaughter act marks an important in the long-standing Anglo-Saxon debate on corporate criminal liability⁸⁴. In fact, under English law, the essential problem is that a corporation is granted an independent status by a pragmatic legal fiction which affords an identity to entity which has no physical existence⁸⁵. This is done in order to allow the corporation to assume responsibility and rights in its economic activities and

⁷⁹Bittle, S., & Snider, L. (2006). From manslaughter to preventable accident: Shaping corporate criminal liability, *Law & Policy*, 28.4, 470-496.

⁸⁰Schneider, A. (2014). Corporate Criminal Liability and Conflicts of Jurisdiction. In Brodowski, D., Espinoza de los Monteros de la Parr, M., Tiedemann, K., Vogel, J. (Eds.), *Regulating Corporate Criminal Liability*. New York: Springer International Publishing, 249-260.

⁸¹Gobert, J. (2008). The Corporate Manslaughter and Corporate Homicide Act 2007—Thirteen years in the making but was it worth the wait?. *The Modern Law Review*, 71.3, 413-433.

⁸² Schneider, U.H. (2008). Auslaendisches Unternehmensstrafrecht und Compliance. *CCZ - Corporate Compliance Zeitschrift*, 18.

⁸³*Manslaughter, Corporate, and Corporate Homicide Act (2007)*.

⁸⁴Bergman, D. (2000). Manslaughter and corporate immunity. *New Law Journal*, 316-317.

⁸⁵Radin, M. (1932). The Endless Problem of Corporate Personality. *Colum. L. Rev. - Columbia Law Review*, 32, 643.

this device has proved extremely useful in encouraging commercial risk taking and entrepreneurial activity⁸⁶. However, problems arise when it is necessary to consider the question of the criminal liability of the corporation, because one of the fundamental precepts of criminal law is that of personal criminal responsibility. The way in which criminal law attributes liability is by ascertaining a guilty mind and a guilty act on the part of the accused⁸⁷. It is difficult to accuse a company of possessing a guilty mind, because it has no personal mind or conscience⁸⁸, and it is guilty of accusing a company of a guilty act, because it is a legal construct without any means of acting on its own behalf. Companies can only act vicariously⁸⁹ through the actions of their human employees and representatives, and such individuals possess their own personal criminal responsibility which can be dealt with by the ordinary application of criminal law. Given that the company has no conscience or mind of its own, it has been suggested that the law should look to a senior representative of the company and attribute his or her state of mind to the company itself (s.c. "directing mind" theory). This is a tenuous approach, because it undermines the fundamental rule of personal criminal responsibility, but it has received considerable academic support and comment. The

⁸⁶ Thompson, R.B. (1994). Unpacking Limited Liability: Direct and Vicarious Liability of Corporate Participants for Torts of the Enterprise. *Vanderbilt Law Review*, 47,1.

⁸⁷ Arlen, J., & Kraakman R. (1997). Controlling Corporate Misconduct: An Analysis of corporate Liability Regimes. *N.Y.U. L. Rev. - New York University Law Review*, 72.

⁸⁸In this respect, one can recall Coffee, J.C., Jr., 1980, "No Soul To Damn: No Body to Kick": An Unscandalized Inquiry Into the Problem of Corporate Punishment, 79 Mich. L. Rev. 386 with the famous quote of Edward, First Baron Thurlow: "Did you ever expect a corporation to have a conscience, when it has no soul to be damned, and no body to be kicked?".

⁸⁹ Thompson, R.B. (1994). Unpacking Limited Liability: Direct and Vicarious Liability of Corporate Participants for Torts of the Enterprise. *Vanderbilt Law Review*, 47,1.

traditional starting point in an analysis of the evolution of directing mind theory is the dictum of Viscount Haldane in the civil case, *Lennard's Carrying Co Ltd v Asiatic Petroleum Co Ltd*⁹⁰. He stated:

“A corporation is an abstraction. It has no mind of its own any more than it has a body of its own; its active and directing will must consequently be sought in the person of somebody who for some purposes may be called an agent, but who is really the directing mind and will of the corporation, the very ego and centre of the personality of the corporation.”

In the case of *H.L. Bolton (Engineering) Co Ltd v T.J.Graham & Sons Ltd*⁹¹, Lord Denning attempted to entrench directing mind theory at the heart of the law for the imposition of civil or criminal liability on companies. Lord Denning stated that companies:

“may in many ways be likened to a human body. They have a brain and a nerve centre which controls what they do. They also have hands which hold the tools and act in accordance with directions from the centre”.

Therefore Lord Denning advocated that the means of determining the mind of the company was to identify its actual human controllers. He argued that a

⁹⁰*Lennard's Carrying Co Ltd v Asiatic Petroleum Co Ltd* [1915] AC 705.

⁹¹*HL Bolton (Engineering) Co Ltd -v- TJ Graham & Sons Ltd*, CA 1957.

company's directors and managers represent the directing mind and will of the company, and that they control what the company does⁹². He concluded that the state of mind of senior corporate officers is the state of mind of the company and that it should be treated by the law as such. Unfortunately, Denning's policy rendered it virtually impossible for corporations of anything⁹³ other than a very small size to be successfully prosecuted because in most corporations of a significant size the personal responsibility for corporate affairs is divided between a number of directors and senior managers and as a consequence, no single human component of the company is responsible for sufficient of the mens rea and actus reus in order to found a criminal prosecution. The "directing mind" theory was further refined by Lord Ried⁹⁴ in the case *Tesco Supermarkets vs. Nattra* in 1972. Lord Ried observed that:

Normally the board of directors, the managing director and perhaps other superior officers of a company carry out the functions of management and speak and act as the company. Their subordinates do not. They carry out orders from above and it can make no difference that they are given some measure of discretion. But the board of directors may delegate some part of their functions of management giving to their delegate full discretion to act independently of instructions from them. I see

⁹²Clarkson, C. (1996). Kicking corporate bodies and damning their souls. *The Modern Law Review* 59.4, 557-572.

⁹³Sahni, B. (2005). Interpretation of the Corporate Personality of Transnational Corporation. *Widener LJ - Widener Law Journal*, 15, 1.

⁹⁴Stern, Y. Z. (1987). Corporate Criminal Personal Liability-Who Is the Corporation. *J. Corp. L. - Journal of Corporation Law* 13, 125.

no difficulty in holding that they have thereby put such a delegate in their place so that within the scope of the delegation he can act as the company.

The “directing mind” theory, however, was not flawless, as it required complex investigations to identify the “directing mind” within a company, making careful distinctions based on “seniority”, “control” and “autonomy”⁹⁵. While this might be easy in the case of a small company, a large modern corporation active in different jurisdictions would typically make the identification process a very burdensome one⁹⁶. Ultimately, this would result into an asymmetry of treatment between large companies and small ones. With this in mind, it is evident that the approach embedded in the Manslaughter act is radically different, as it does not even attempt to use the role of corporate officers as attribution criterion. Instead, a different criterion is adopted, namely the fact that the corporate activities can substantially contribute to a crime. Because Manslaughter uses an approach that requires an evaluation of an organization’s management and organization⁹⁷, this is likely to increase the pivotal role of compliance within corporate groups which do business *with-* not necessarily *in* - the United Kingdom

⁹⁵Ferran, E. (2011). Corporate Attribution and the Directing Mind and Will. *Law Quarterly Review* 127, 239-259.

⁹⁶Field, S., & Jorg, N. (1991). Corporate-liability and Manslaughter- Should we be going Dutch. *Criminal Law Review*, 156-171.

⁹⁷Gobert, J. (2008). The Corporate Manslaughter and Corporate Homicide Act 2007- Thirteen years in the making but was it worth the wait?. *The Modern Law Review* 71.3, 413-433.

Chapter 4: Compliance and foreign courtrooms

12. In this respect, one should also recall a 2004 Italian case-law landmark case. In this verdict, an Italian court held a German corporate group, Siemens, not resident in Italy and operating in Italy only through a temporary company grouping (s.c. “associazione temporanea d’impresa”) accountable for criminal offences (namely: bribery) committed in Italy⁹⁸. Back in 2004, the Italian Supreme Criminal Court stated that Italian criminal laws are applicable to a criminal offence committed abroad if there is *any* connection with Italy⁹⁹, even if the connection is not per se a criminal breach, the rationale being that the connection “has to be regarded as a fragment of larger criminal sequence that should not be taken singularly”¹⁰⁰. Moreover, the Italian court held the Siemens holding company liable¹⁰¹ even if, not being incorporated in Italy, it had no Italian compliance organization nor programs – these programs are explicitly foreseen

⁹⁸In the Siemens Case, the Court of Milan, in its verdict of 28 October 2004, stated that it is almost self-evident that foreigners (both individuals and legal entities), when acting in Italy, shall comply with Italian legislation, regardless of the fact that similar rules exist in their country of origin.

⁹⁹One should also recall that, by symmetry, section 4 of Law No. 231/2001 foresees the application of Italian criminal laws – and sanctions – to entities which have their main seat in Italy and commit violations abroad.

¹⁰⁰ Italian Criminal Court, Siemens case, Sentence no. 4284/2000.

¹⁰¹Rizzi, R., & Rahman, N. (2005). Why Limiting Liability in Italy Just Got Harder. *Int'l Fin. L. Rev. - International Financial Law Review*, 24 - 25; Wrage, A., & Richardson, A. (2009). Siemens AG-Violations of the Foreign Corrupt Practices Act. *ILM – International Legal Materials*, 48, 232.

under the Italian domestic discipline¹⁰². One could also wonder what their judgment would have looked like, if the holding company had had in place such risk management programs. More specifically, one might ask whether the existence of these organizations¹⁰³ would have avoided the application of Italian law onto a non-resident company. Another important judgment by an Italian court is the June 13 2007 verdict by the Tribunal of Milano (judge Tacconi), where it was stated that the corporate liability regime foreseen under Legislative Decree no. 231/01 as well as general Italian criminal law is applicable to foreign banks which have no subsidiary in Italy but are active in Italy. Regrettably, also this judgement does not provide any additional element as to the value and comparability of compliance and/or risk management programs adopted by a foreign bank.

Chapter 5: Contents of the Compliance Duty

13. As far as a *general* duty to establish a compliance department exists, its contents must be examined. As a preliminary remark, one can argue that there are few specifications of this duty, and existing ones only apply to specific topics/industries/businesses, so analogy is the only way to draw a parallel among the the contents of the general duty and those of specific rules. In Germany, for example, specifications are contained in Section 33 of

¹⁰²Castaldo, A. & Nizi, G. (2007). Entity Liability and Deterrence: Recent Reforms in Italy. *Erasmus L. & Econ. Rev. - Erasmus Law & Economics Review*, 1, 1-8.

¹⁰³Bevilacqua, F.C. (2006). Corporate compliance programmes under Italian law. *Ethikos*, November/December. Available at: <http://www.singerpubs.com/ethikos/html/italy.html>.

the Securities Trading Act (Wertpapierhandelsgesetz (WpHG)) or in the Minimum Requirements for the Compliance Function and Additional Requirements Governing Rules of Conduct, Organisation and Transparency (MaComp). Yet, as far as other companies are concerned, there are no specifications for the compliance department. Thus, general principles and elements can be pointed out when assessing the main features of the compliance department. According to Schneider¹⁰⁴ compliance is in its essence a three-pronged duty that covers:

- ✓ the *personal behavioural duties* of the board members and company employees;
- ✓ the *organizational duties* of the management bodies, i.e. the duty to set up and manage an organization, a system with the aim to ensure that the company and its employees behave in accordance with the law and other principles, and that breaches and violations are discovered in a timely and efficient manner;
- ✓ a *breach pre-emption and damage avoidance* duty in the hands of the members of corporate bodies, i.e. a duty to avoid legal breaches - and damage deriving therefrom to the company's value.

With this in mind, it is also worth recalling that the scope and size of directors' duties are inextricably connected and commensurate to the type and size of the company, as well as on the complexity of the regulatory environment in which it operates. In Germany, this can for instance be deducted from Section 33 of the

¹⁰⁴Schneider, U.H., & Schneider, S.H. (2007). Konzern-Compliance als Aufgabe der Konzernleitung, *ZIP - Zeitschrift für Wirtschaftsrecht*, 44, 2061.

WpHG, whose basic rule is that the larger the company and the more likely it is that pursuing its business aims can cause harm to the general public, the more one has to take into consideration the underlying aim and purpose of the WpHG. It should specifically be noted that it is a guiding principle that compliance must be organised in such a way that violations of law can be efficiently prevented.

Chapter 6: The Duty of Compliance and the Business Judgement Rule

14. As we have pointed out earlier in this research, it is not always clear whether a corporate board has a duty, in the best interests of and for the benefit of the company, to establish an institution within the company which reveals violations of law and helps to prevent them, as this would be a duty other from those cases in which there is such a specific legal requirement¹⁰⁵. According to Casper, the duty to establish a compliance department does not involve or require a “business decision” as the establishment of such a department is a non-discretionary and binding legal requirement for certain companies. The discretion only applies at a later stage, as to “how” structure the compliance organization. According to Schneider, even the substantive and specific laws requiring the establishment of a compliance department can be

¹⁰⁵In favour of this Schneider, U.H. (2003). Compliance als Aufgabe der Unternehmensleitung. *ZIP - Zeitschrift für Wirtschaftsrecht*, 24,645 and foll.; Buerkle, J. (2005). Corporate Compliance - Pflicht oder Kuer fuer den Vorstand der AG?. *BB - Betriebs - Berater*, 60, 565 and foll..

seen as the expressions of a general duty to actually set up a compliance department¹⁰⁶. In those cases in which the establishment of a compliance department is a requirement explicitly foreseen by the law, if the board – in Germany it is the management board – breaches the duty to establish a compliance department or to provide it with sufficient personnel, non-cash resources or competences, it may become liable towards the company. This requires, however, that it should be proved that the company has suffered damage as a result of this breach. Moreover, in Germany it is also controversial¹⁰⁷ whether the members of the management board may be able to invoke the so-called “business judgment rule” under Section 93(1) cl. 2 of the AktG to avoid such a liability. According to such rule, managerial conduct cannot be judicially reviewed, when four prerequisites are fulfilled:

- i. A business decision was taken (“unternehmerische Entscheidung”);
- ii. The decision was taken in the best interests of the corporation (“zum Wohle der Gesellschaft”);
- iii. The decision was taken in good faith, or, closer to the wording of the provision, the person could reasonably believe (“vernunftigerweise annehmen durfte”) that it was a business decision taken in the best

¹⁰⁶Schneider, U.H. (2003). Compliance als Aufgabe der Unternehmensleitung. *24 ZIP - Zeitschrift für Wirtschaftsrecht*, 645 and foll..

¹⁰⁷See for example Reichert, J., & Ott, N. (2009). Non Compliance in der AG – Vorstandspflichten im Zusammenhang mit der Aufklärung und Sanktionierung von Rechtsverstößen. *ZIP - Zeitschrift für Wirtschaftsrecht*, 30, 2173 – 2176; Meier-Greve, D. (2009). Vorstandshaftung wegen mangelhafter Corporate Compliance. *BB – Betriebs - Berater*, 64, 2555 – 2557 (both with further bibliography); for a monograph see Geiser, M., (2012). *Grenzziehung zwischen der Business Judgment Rule und den notwendigen Anforderungen an eine Compliance-Organisation*. Hamburg: Dr. Kovac̃ Verlag, 42 and foll..

interests of the corporation, which implies that the person must be unbiased and has no conflicts of interests; and

- iv. The decision was reached based on appropriate information (angemessener Information) or, put more generally, an informed decision was taken.

According to Casper, the “business judgement rule” cannot be invoked in those cases in which the establishment of a compliance department is a non-discretionary act that stems from a precise legal requirement. This is different from the decision as to how shape and organize the compliance department – a decision for which there is no strict and specific legal requirement. In this regard, therefore, the business judgement rule is applicable and may protect the management board if all the other prerequisites for the protection are present.

Chapter 7: Requirements of the Compliance Department

15. Arguably, a key requirement for the compliance organisation, is its independence. For the Basel Committee on Banking Supervision, considering compliance in a bank, this means that: “the compliance function should have a formal status within the bank. Second, there should be a group compliance officer or head of compliance with overall responsibility for co-ordinating the management of the bank’s compliance risk. Third, compliance function staff, and in particular, the head of compliance, should not be placed in a position where there is a possible conflict of interest between their compliance

responsibilities and any other responsibilities they may have. Fourth, compliance function staff should have access to the information and personnel necessary to carry out their responsibilities”¹⁰⁸. Because the compliance organisation has to be independent, it should be organised as a separate department. In this respect, it is important to distinguish between the **separation from operative departments** and **separation from the board**. Some countries have a **dual board** structure, common in Germany but also used in other European and Asian countries, foreseeing a structure of corporate governance in which shareholders (and often workers) elect members of a supervisory board, which then appoints and supervises a management board.

16. As far as independence from operative units/departments is concerned, the compliance department should be separated from the operational part of the company’s business activities. Moreover, this does not preclude the fact that the compliance department can be combined with other, already existing departments also matching the same separation principle. It is also important to recall that compliance may not always be concentrated in the compliance department, but can be allocated in a variety of corporate functions. As the Basel Committee on Banking Supervision noted back in 2005: “Not all compliance responsibilities are necessarily carried out by a “compliance department” or “compliance unit”. Compliance responsibilities may be exercised by staff in different departments. In some banks, for example, legal and compliance may be separate departments; the legal department may be

¹⁰⁸<http://www.bis.org/publ/bcbs113.pdf>.

responsible for advising management on the compliance laws, rules and standards and for preparing guidance to staff, while the compliance department may be responsible for monitoring compliance with the policies and procedures and reporting to management. In other banks, parts of the compliance function may be located within the operational risk group or within a more general risk management group. If there is a division of responsibilities between departments, the allocation of responsibilities to each department should be clear. There should also be appropriate mechanisms for co-operation among each department and with the head of compliance (e.g. with respect to the provision and exchange of relevant advice and information). These mechanisms should be sufficient to ensure that the head of compliance can perform his or her responsibilities effectively"¹⁰⁹. The compliance organization can be combined with the legal department, provided it is separate from the company's operations as well. The controlling department is also frequently quoted as an alternative match¹¹⁰. Compliance officers may end up holding dual roles in their company. Where the compliance officer holds a role such as Legal Counsel or Head of Internal Audit or is a qualified or chartered

¹⁰⁹<http://www.bis.org/publ/bcbs113.pdf>.

¹¹⁰For details on the differences between compliance, controlling and auditing see in particular Dreher, M., (2010). Die Vorstandsverantwortung im Geflecht von Risikomanagement, Compliance und interner Revision. In Kindler, P., Koch, J., Ulmer, P., & Winter, M. (Eds.), *Festschrift für Uwe Hüffer zum 70. Geburtstag*. München:CH Beck Verlag, 161 and foll.; AKEIU - Arbeitskreis Externe und Interne Ueberwachung der Unternehmung der Schmalenbachen-Gesellschaft fuer Betriebswirtschaft, (2010). Compliance: 10 Thesen fuer die Unternehmenspraxis. *DB - Der Betrieb*, 63, 1509-1518. For the advantages of a Compliance-Management-Systems with a Compliance Council (instead of a CCO) - see Goetzwein, G., & Hohmann, O. (2011). Modelle der Compliance-Organisation im Unternehmen. *BB - Betriebs - Berater*, 66, 963 and foll..

professional such as an attorney or accountant, there is the possibility that a clash will occur between her/his professional obligations and duties to the company as a compliance officer. For example, such employees will have a heightened fiduciary responsibility to raise concerns and uphold a public interest requirement.

17. As far as independence from the management board is concerned, because of the fact that the compliance department must be subordinated to the management board, it can be said that the compliance department should not be subordinated to any other employees of the company. By contrast, it is not necessary that there is an independent position, free from instructions received from the management board. This follows from the fact that it is a specific management duty of the management board to ensure compliance with the law within the company, which can then be delegated to the compliance department¹¹¹ (but without the management board losing its duty nor its responsibility as a collegiate body: *“Compliance ist eine Führungsaufgabe, von der sich der Vorstand nicht befreien kann”*¹¹²). In this respect, the recent Neubuerger judgement by the Regional Court of Munich¹¹³ clarified that according to the Regional Court of Munich, the board may not delegate the implementation of

¹¹¹ Casper, M. (2012). Corporate Governance and Corporate Compliance. In du Plessis, J.J., Großfeld, B., Luttermann, C., Saenger, I., Sandrock, O., & Casper, M. (Eds.), *German Corporate Governance in International and European Context*. Berlin - Heidelberg: Springer, 359-397.

¹¹² Schneider, U.H., & Schneider, S.H. (2007). Konzern-Compliance als Aufgabe der Konzernleitung. *ZIP - Zeitschrift für Wirtschaftsrecht*, 44, 2065.

¹¹³ Regional Court of Munich, decision of December 10, 2013, file no. 5 HK O 1387/10, “Siemens” – case / decision published end of March 2014.

the compliance system¹¹⁴ in detail to a lower level (“division managers”)¹¹⁵. More specifically: the board must check out for itself whether and how the compliance system is implemented and whether it is appropriate and functional.

18. A controversy on the independence of the compliance department, in particular of the company compliance officer (CCO), could arise. In fact, if the criterion of independence is stretched to its limit, the CCO’s independence could be meant not only in regard to the subsidiary levels within the company, i.e. all operative departments or divisions of the company, but also vis-à-vis the management board. If this line of reasoning is applied, either protection from

¹¹⁴In the case in question, Siemens, a globally active company brought an action for compensation against a former member of the board due to a breach of duty. Employees of the plaintiff had created and managed so called “black accounts”. The money had been used for bribe payments abroad, totalling several millions. These payments led i.a. to a supervisory proceeding subject to stock exchange law in the USA and to a criminal proceeding against the plaintiff in Germany. At home and abroad, fines running into billions have been imposed on the plaintiff. For the internal investigations on the system of black accounts, the plaintiff engaged a law firm after its discovery. Siemens justified its claim for compensation by stating the board (negligently) breached its duty to ensure a lawful behaviour of the company. The defendant as board member did not ensure that the company establishes an efficient compliance system with preventive effects, which is actually applied and controlled. The board member defended himself against the claim for damage i.a. on the ground that the compliance system was not part of the board department under his responsibility. He had adopted for his department corresponding directives to prevent dubious payments. Division managers were responsible for the practical implementation. The court accepted the arguments of the applicant company. The court sentenced the board member to pay compensation in the amount of in total EUR 15 m. including law-yers’ fees in the amount of EUR 12.85 m. although the board member concerned neither knew the system of black accounts nor knew the corrupt payments and was just one of ten board members at that time.

¹¹⁵Fleischer, H. (2014). Aktienrechtliche Compliance-Pflichten im Praxistest: Das Siemens/Neubürger-Urteil des LG München I. *Neue Zeitschrift für Gesellschaftsrecht*, 17, 321-329.

dismissal or no profit-related compensation could be envisaged for the CCO and the compliance department in order to protect him from retaliations resulting into job loss or salaries discretionality¹¹⁶. On this note, back in 2005 also the Basel Committee on Banking Supervision highlights that: *“The independence of compliance function staff may also be undermined if their remuneration is related to the financial performance of the business line for which they exercise compliance responsibilities. However, remuneration related to the financial performance of the bank as a whole should generally be acceptable”*¹¹⁷.

Chapter 8: Management Board, Supervisory Board and the Compliance Department

19. Besides the issue of the compliance department’s independence and its *status vis-à-vis* the management board, it is also important to examine the mutual interaction between the management board and the compliance department. In fact, despite the need to safeguard the department’s independence, this does not mean that it can always act without following the direction of the management board. This aspect is particularly clear when one considers the fact that at the heart of the compliance department is the need to retrieve and analyse information flows. Indeed, the compliance department must have access to the necessary information flows within the company in

¹¹⁶Krieger, S., & Guenther, J. (2010). Die arbeitsrechtliche Stellung des Compliance-Officers. *NZA -Neue Zeitschrift für Arbeitsrecht* , 27, 367- 369.

¹¹⁷<http://www.bis.org/publ/bcbs113.pdf>

order to perform its task in an effective way. But this does not mean that, at any time, it is in a position to gain access to all information or to interrogate employees in the company. In principle, as a staff department, the compliance department must follow the directions of the management board. In fact, the management board may give the compliance department permission to permanent access to particular information systems and the right to an anticipated interrogation of employees. Also in this case, access to information should be commensurate to the nature of the company. Indeed, the recently released ISO 19600 standard on compliance management systems¹¹⁸ lists several examples of collection methods¹¹⁹ and specifies that *“there are many methods for collecting information. Each method listed below is relevant in different circumstances and care should be taken to select the variety of tools appropriate to the size, scale, nature and complexity of the organization”*.

20. Another important element necessary to examine the role of the compliance department in the context of corporate governance is its relationship with the body entrusted with supervisory activity. As recalled supra under par. 1, in Germany this body is the supervisory board, while in

¹¹⁸http://www.iso.org/iso/catalogue_detail.htm?csnumber=62342

¹¹⁹ Examples of information collection include: – ad hoc reports of noncompliance as they emerge or are identified; – information gained through hot lines, complaints and other feedback, including whistle blowing; – informal discussions, workshops and focus groups; – sampling and integrity testing, such as mystery shopping; – results of perception surveys; – direct observations, formal interviews, facility tours and inspections; – audits and reviews; – stakeholder queries, training requests and feedback provided during training (particularly those of employees).

Italy this role is embodied by the “*Collegio Sindacale*”. According to Casper¹²⁰, three questions arise. First, in what amount of detail does the supervisory board have to monitor the effective establishment of a compliance department? Secondly, to what extent does the supervisory board have to perform examinations or investigations, e.g. in the form of random checks, to monitor the efficiency of the work of the compliance department? Lastly, do individual infringements of law provide a reason for investigations by the supervisory board itself or can it rely on the fact that the management board, through intermediation by the compliance department, is pursuing such infringements?

21. If the management board has not established a compliance department because a decision has been made that it is unnecessary in respect of the current circumstances of the company, the supervisory board has to examine independently within the framework of a risk analysis, whether a formal compliance organisation is really dispensable. This is part, in fact, of the general duty to examine the company organisation foreseen for the supervisory board or its equivalent. For instance, pursuant to art. 2403 of the Italian Civil Code: “*Il collegio sindacale vigila [...] sull'adeguatezza dell'assetto organizzativo[...] adottato dalla società e sul suo concreto funzionamento*”, i.e. the “*Collegio Sindacale*” (equivalent for many tasks to the German supervisory board) has supervisory duties regarding the adequacy of the company’s organization, and its actual functioning”. This supervisory duty does not only entail formal checks, but also

¹²⁰Casper, M. (2012). Corporate Governance and Corporate Compliance. In Du Plessis, J.J., Großfeld, B., Luttermann, C., Saenger, I., Sandrock, O., & Casper, M. (Eds.), *German Corporate Governance. International and European Context*. Berlin-Heidelberg: Springer, 359-378.

reviews of the actual organization¹²¹. It is commonly maintained that the compliance department's staff shall generally not be involved in the activities they monitor. However, a combination of the compliance function with other control units at the same level (such as money laundering prevention) may be acceptable if this does not generate conflicts of interests or compromise the effectiveness of the compliance function. Combining the compliance function with audit functions shall generally be avoided as this is likely to undermine the independence of the compliance function because audit is charged with the oversight of the compliance function. However, for practical reasons (for example, decision making), and in certain circumstances (for example, in investment services providers of only two persons), it may be more appropriate to have one body responsible for both functions. Whether staff from other control functions also performs compliance tasks, shall also be a relevant consideration in the determination of the relevant number of staff necessary for the compliance function. With this in mind, in Italy it has been pointed out that the fact that the Italian Collegio Sindacale can coincide with the Compliance Department (Organismo di Vigilanza) is legally problematic¹²². In fact, not only are the functions of the compliance department and the Collegio Sindacale different in their nature, but the Collegio Sindacale is regarded as a potential addressee of white collar crimes (such as those foreseen under Art. 2368 of the Italian Civil Code). Moreover, it has been pointed out earlier that the

¹²¹Montalenti, P. (2009). Organismo di vigilanza e sistema dei controlli. *Giur. Comm. - Giurisprudenza commerciale*, 4, 643.

¹²²Tombari, U. (2013). *Corporate governance e «sistema dei controlli» nella spa*. Torino: Giappichelli Editore.

management board is no **assistant public prosecutor** (*“Hilfsbeamter der Staatsanwaltschaft”*), whereas in Italy the Collegio Sindacale can be¹²³. Hence, it is controversial what happens in those cases in which the Compliance Department coincides with the Collegio Sindacale, and whether the latter loses its status of guarantor of enforcement or the status of guarantor is extended to the Compliance Department¹²⁴.

22. If a compliance department has been established by the management board, then the examination task of the supervisory board has several focal points. First, the supervisory board has to examine the mutual relation between the management board and the compliance department, i.e. whether the management board monitors the compliance department and complies with the guidelines which it has set up itself. For instance, the supervisory board may want to check that the head of the compliance department (CCO) reports at least monthly to the management board. Secondly, the supervisory board has to examine whether the compliance department adheres to the policies for its work set up by the management board (i.e. its actual functioning and not merely its formal existence). Additionally, the efficiency of the compliance department has to be examined¹²⁵. In regard to the degree of detail of the

¹²³Valensise, P. (2009). L'organismo di vigilanza ex d. lgs. n. 231/01: considerazioni su poteri, composizione e responsabilità. *Analisi Giuridica dell'Economia*, 8(2), 355-382.

¹²⁴D'Aponte, M. (2014). *Autorità e indipendenza della commissione di garanzia nei conflitti sindacali*. Torino: Giappichelli Editore.

¹²⁵Casper, M. (2012). Corporate Governance and Corporate Compliance. In Du Plessis, J.J., Großfeld, B., Luttermann, C., Saenger, I., Sandrock, O., & Casper, M. (Eds.), *German Corporate Governance. International and European Context*. Berlin - Heidelberg: Springer, 359-378.

monitoring by the supervisory board, it is guided by several factors; apart from the size of the company, it must consider how frequently violations of law have occurred in the company and which risk level is associated with the type of business in which the company is involved. However, as a general rule, the supervisory board cannot be required to investigate on a random basis whether violations of law have been committed within the company¹²⁶. Such random investigations would jeopardise the trusting cooperation between the management board and the supervisory board. The report of the management board is the sole source of information for the supervisory board which, again as a general rule, may rely on its accuracy, as the management board is obligated to utmost honesty in their relationship with the supervisory board. Some commentators argue in favour of an extensive right of the supervisory board to gather information¹²⁷, particularly a right to interrogate employees in the absence of the management board, although this may negatively affect the working atmosphere and the trusting cooperation between the management board and the supervisory board. A direct line of authority from the supervisory board towards either the compliance department or employees of the company can only be justified if actual suspicious circumstances exist, and the management board or the compliance department are not trying to clarify the situation. It is, however, recommended, as an initial step, that the supervisory board has to ask the management board first to invite the head of the

¹²⁶Fleischer, H. (2008). Corporate Compliance im aktienrechtlichen Unternehmensverbund. *CCZ - Corporate Compliance Zeitschrift*, 1(1), 1-6.

¹²⁷ Nonnenmacher, R., Pohle, K., & von Werder, A. (2007). Aktuelle Anforderungen an Prüfungsausschüsse - Leitfaden fuer Prüfungsausschüsse (Audit Committees) unter Berücksichtigung der 8. EU-Richtlinie, *DB- Der Betrieb*, 60, 2412 - 2415.

compliance department to a meeting of the supervisory board in order to receive a direct report from the compliance officer regarding compliance activities within the company. However, a duty of the compliance officer to report to the supervisory board does not exist in principle. The only exception to this would be if the management board as a whole was involved in breaches relating to compliance issues. Whereas the supervisory board may normally be satisfied with receiving periodic reports from the management board, the supervisory board may initiate further investigations if there are discrepancies in the reports, or if the reports contain details about an accumulation of incidents relevant to compliance. More stringent standards for the examination may be applied to such members of the supervisory board who have previously held a mandate within the management board and as a result of that have special knowledge¹²⁸.

23. Whose is the responsibility to monitor the compliance department? The answer to this question is a tricky one, as each jurisdiction varies – sometimes significantly. In Italy, for instance, the compliance department’s functions can be attributed to the “Collegio Sindacale”, and indeed this is a frequent practice for small companies. The Collegio Sindacale shall be appointed by the Board of Directors (Consiglio di Amministrazione), as a collegiate body (i.e. not just one or some of its members), and this appointment is not considered an element that undermines the “Collegio Sindacale”’s own independence. Moreover, the

¹²⁸Winter, M., (2010). Die Verantwortlichkeit des Aufsichtsrats für “Corporate Compliance”. In Kindler, P., Koch, J., Ulmer, P., & Winter M. (Eds.), *Festschrift fuer Uwe Hueffer zum 70. Geburtstag*. München: CH Beck Verlag, 1103 – 1123.

very fact that the Collegio Sindacale carries out the activities of a compliance department excludes that it can monitor it. In German literature, it is asked for example whether the monitoring of the compliance department can be delegated to the Audit Committee, a committee whose establishment is not mandatory, but permitted - and even recommend. The duties of the Audit Committee include, inter alia, questions of compliance. If the supervisory board delegates questions of compliance to the Audit Committee, the duties explained above are transferred to that committee. In such a case, the members of the supervisory board as a whole, who are not part of the Audit Committee, are freed from these duties as they have no duty to act. According to Section 107(3) No 4 of the AktG, the duty of the remaining members of the supervisory board in that situation is limited to monitoring within the framework of the frequent reports of the committee to the plenum as a whole. Corporate responsibility for the task of control rests with the supervisory board as a collegiate body¹²⁹.

Chapter 9: Compliance Officers and Liability

24. Having analysed the contours of the compliance department's duties and its status relative to other bodies within the company, also the liability of the compliance officers should be considered. As a preliminary remark, there is no

¹²⁹Casper, M. (2012). Corporate Governance and Corporate Compliance. In Du Plessis, J.J., Großfeld, B., Luttermann, C., Saenger, I., Sandrock, O., & Casper, M. (Eds.), *German Corporate Governance. International and European Context*. Berlin - Heidelberg: Springer, 359-397.

standard description as responsibilities will depend on the context and the needs of the company. In many cases, the role of compliance officers within organisations is still being defined¹³⁰. The position of the compliance officer could involve policy owning responsibilities, such as ensuring that controls are in place, managed appropriately and complied with, or the compliance officer may be a voluntary, supportive part-time role with the employee simply acting as a local point of contact. Many factors influence a compliance officer's exposure to personal liability. While all employees have a responsibility to abide by the law and the terms and conditions of their employment contract (whether that be written or not), it is not always the case that employees understand their responsibilities (documented or assumed), nor their potential exposure to personal risk and liability. Furthermore, the spectrum of employees carrying out the compliance officer role is likely to include those with specified professional duties, e.g. accountants and lawyers, and/or varying seniority. The obligations imposed by their professional body or their "officer status" in the company will influence the liability context within which these individuals work. Also, some job titles are significant. For example, ombudsman and auditor can be defined in some jurisdictions as technically and legally specific roles and this will determine their legal responsibilities and privileges etc. Finally, liability can be prescribed because of particular duties assigned specifically to the compliance department officer role. For example, in the US,

¹³⁰Schneider, H., & Gottschaldt, P. (2011). Offene Grundsatzfragen der strafrechtlichen Verantwortlichkeit von Compliance-Beauftragten in Unternehmen. *ZIS- Zeitschrift für Internationale Strafrechtsdogmatik*. Available at: http://www.zis-online.com/dat/artikel/2011_7_593.pdf.

compliance officers in the securities industry are more exposed to the risk of personal liability if they have supervisory duties rather than solely a monitoring role. In some jurisdictions, legal liability may be formally “delegated” to senior employees in their employment contract. In practice employment contracts are not always updated to reflect a new role or evolving responsibilities and the accompanying changes in liabilities. In some jurisdictions (for example France and Germany), the Board or a senior officer of the company may, in a separate written document, formally set out a senior employee’s delegated duties and authorities with accompanying legal and criminal liabilities. The delegee can further delegate his/her powers, but not the associated liabilities. Where delegations of authority and duties have been formally made, and an employee is acting within the scope of their duties, the employer would generally be expected to be vicariously liable for a wrongdoing, together with the employee.

25. In 2008, the Head of Internal Audit and Legal at a public cleaning service company, “Berliner Stadtreinigung¹³¹” (owned by the State of Berlin), was convicted for failing to act on evidence of customer overcharging. When he became aware of the systematic overcharging, in the region of some €23 million, he informed a member of the company’s board, who instructed him not to correct the error. The German Bundesgerichtshof (Federal Supreme Court) convicted and imprisoned the Head of Internal Audit and Legal on the basis that he had assisted fraud by failing to act, i.e. to take his concerns to a higher

¹³¹ BGH 5 StR 394/08.

level. In another case in November 2011, the UK's Financial Services Authority (FSA) imposed a fine of £14,000 on a compliance officer at a hedge fund management company (Dynamic Decisions Capital Management). She had failed "to challenge a colleague, [and] investigate and act on the information she received" following concerns raised by investors around the sale of a bond. The FSA concluded that she "did not engage with her responsibilities...and therefore failed to act with due skill and care" and neglected "to understand the importance of her role and the wider regulatory obligations it brings".

26. With a view to the case recalled in the previous paragraph, the German Bundesgerichtshof (Federal High Court of Justice) expressly stated that a compliance officer (not at board level) is obliged to avert criminal acts committed by employees of the organisation to the detriment of third parties¹³². In fact it is not the compliance officer's primary duty to protect the company from attacks and damages, as is the case, for example, with auditing (preventing breach of trust and embezzlement at the company's expense) and measures for the protection of security of the works (preventing unauthorized persons from entering). Rather, compliance's duty - and, therefore, the employees' duty who work in that area - is the prevention of illegal acts having effect within the company (e.g. violation of regulations for the protection of employees) and outside of the company (e.g. cartel agreements or the use of company computers to exchange child pornography). The compliance officer

¹³² The court stated that "the duty of a Compliance Officer is to prevent infringements of the law, especially crimes, which are conducted out of the company. Such Officers regularly have a duty to act according to sec. 13 Penal Code".

can also take on additional tasks, such as a data security, money laundering or an export control officer¹³³. By accepting these duties compliance officers assume a special legal position, which distinguishes them from the other employees within the company. In the United States, the specific monitoring or supervisory duties of non-board member compliance officers actually varies by industry. Presently, compliance officers in the securities industry are the most heavily regulated¹³⁴. They make up a very unique subset of the compliance activity in the US, so it is difficult to say whether the guidelines provide an indication of where the law of personal liability for other compliance officers might head, but following them may minimise their risk of personal liability under US law. Then again, securities firms are required by law to have chief compliance officers with primary responsibility for administering those policies and procedures designed to prevent violations of the applicable securities laws and regulations. The SEC is authorised to sanction securities firms and their officers for failing to reasonably supervise another person who is subject to their supervision. However, two things are worth noting. Firstly, in order to address concerns about the scope of personal liability, having the title of chief compliance officer does not, in and of itself, carry supervisory responsibilities¹³⁵. They have to be formally assigned. Secondly, even where compliance officers are deemed to be “supervisors”, US regulation states that

¹³³Goldschmid, H. J. (1997). Fiduciary Duties of Nonprofit Directors and Officer Paradoxes, Problems, and Proposed Reforms. *J. Corp. L. - Journal of Corporation Law*, 23, 631.

¹³⁴Talukdar, A. S. (2005). The Voice of Reason: The Corporate Compliance Officer and the Regulated Corporate Environment. *UC Davis - Business Law Journal*, 6, 45-183.

¹³⁵Oesterle, D. A. (1983). Limits on a Corporation's Protection of its Directors and Officers from Personal Liability. *Wis. L. Rev. - Wisconsin Law Review*, 513.

they will not be deemed to have failed to reasonably supervise another person if they had reasonably discharged their supervisory responsibilities in accordance with the correct procedures¹³⁶. The SEC's stated intent is that the monitoring role of a chief compliance officer does not itself subject the officer to liability.

Chapter 10: Compliance and Whistle-blowing

27. When investigating the scope of activity of a compliance department, it is important to examine whistle-blowing, arguably a key component of compliance systems. The starting point of any argument on the interplay of compliance and whistle-blowing is the importance of information within the company (and the group). Access to information is explicitly mentioned by art. 6, par. 3 of Directive 2006/73/EC of 10 August 2006 implementing Directive 2004/39/EC of the European Parliament and of the Council: *“as regards organisational requirements and operating conditions for investment firms and defined terms for the purposes of that Directive in order to enable the compliance function to discharge its responsibilities properly and independently, Member States shall require investment firms to ensure that the following conditions are satisfied: (a) the compliance function must have the necessary authority, resources, expertise and **access to all relevant information** [...]”*. Moreover, according to the Basel Committee on Banking Supervision, “The compliance function should have the right on its own initiative to communicate with any staff member and obtain access to any

¹³⁶Murphy, D. E. (2001). Federal sentencing guidelines for organizations: a decade of promoting compliance and ethics. *Iowa L. Rev. - Iowa Law Review*, 87, 697.

records or files necessary to enable it to carry out its responsibilities. [...]The compliance function should be able to carry out its responsibilities on its own initiative in all departments of the bank in which compliance risk exists. It should have the right to conduct investigations of possible breaches of the compliance policy [...]The compliance function should be free to report to senior management on any irregularities or possible breaches disclosed by its investigations, without fear of retaliation or disfavour from management or other staff members. Although its normal reporting line should be to senior management, the compliance function should also have the right of direct access to the board of directors or to a committee of the board, bypassing normal reporting lines, when this appears necessary.”¹³⁷ Gathering information, thus, is the first element of any compliance department’s activity, and this is where whistle-blowing fits into compliance. Through whistle-blowing, informants may report (putative) violations of law, usually anonymously. The advantage of an anonymous whistle-blowing-system is the greater willingness of the law abiding employee to reveal violations of law, as he or she does not have to fear retaliations by superiors or by colleagues on whom he or she has been “dobbed in”¹³⁸. On the other hand, the disadvantages are palpable: an anonymous system carries an inherent danger of denunciation as a phenomenon, with an increase in reputation risk for corporate players. Two formats of whistle can be distinguished. In external whistle-blowing systems

¹³⁷<http://www.bis.org/publ/bcbs113.pdf>

¹³⁸Schneider, U. H., & Nowak, C. (2010), Sind die Einrichtung einer Whistleblowing-Stelle und der Schutz des Whistleblowers Teil guter Corporate Compliance. In Hönn/Oetker/Raab, *Festschrift für Peter Kreutz*, S, 855-865.

the informant may reveal himself to an authority that is outside the company and usually public. For this purpose, examples from the USA include: the False Claims Act 1863 (also indicated as Lincoln Law), Section 802 in conjunction with Section 301 of the Sarbanes–Oxley-Act of 2002¹³⁹ in connection with violations of the accounting principles or more recently the Dodd-Frank Act of 2010 with its reward for whistle-blowers, if, due to the information, a fine is successfully imposed. Internal whistle-blowing systems essentially allow employees to report violations of law by colleagues or superiors to a central body within the company without disclosing the identity of the informant to the suspect. Thus, on the one hand, there are systems in which the informant remains completely anonymous while on the other hand there are those in which he or she has to identify him- or herself to the whistle-blowing body, which treats the personal details of the informant as confidential and, in particular, does not disclose them to the suspected persons.

28. In this respect, one cannot help noting that the US approach is significantly different from most European solutions developed so far. The definition of “whistleblower” outside of the United States is itself a subject of debate. For the past two decades, the US has attached whistleblower protection provisions to most law bills in which federal dollars is spent, or which are intended to protect the public from financial loss, nuclear radiation, aviation

¹³⁹Section 301 of SOX requires audit committees of companies listed on a stock exchange to establish “*procedures for the receipt, retention and treatment of complaints received by the issuer regarding accounting, internal accounting controls or auditing matters, and the confidential, anonymous submission by employees of the issuer of concerns regarding questionable accounting or auditing matters*”.

disasters, unsafe trucks on the road, and a wide variety of other harms. For most of the federal whistleblower statutes, the U.S. Department of Labor is assigned to investigate and make findings, and thereafter either the whistleblower or the employer may appeal the decision administratively, and more often, judicially. Instead of this type of US comprehensive whistleblower protection approach, most European Union nations have only a patchwork of whistleblower protections found in employment, criminal, media, and anti - corruption laws, and whistleblowing is mostly permitted but not compulsory. Moreover, adopting a whistleblowing policy may require prior approvals¹⁴⁰, and so far the hypothesis has not been rightly posited that a whistle-blowing system is a necessary part of a compliance system.

Chapter 11: Whistle-blowing and conflict with other legal obligations

29. An interesting aspect of whistle-blowing as a possible part of compliance is the fact that it can entail **conflicts with other obligations**, both general ones and substantive ones. As far as general obligations are concerned, it should be asked for instance whether adopting a whistle-blowing policy could ultimately result into a violation of the general obligation for corporate directors to protect

¹⁴⁰Rauhofer, J. (2007). Blowing the whistle on Sarbanes-Oxley: Anonymous hotlines and the historical stigma of denunciation in modern Germany. *International Review of Law Computers and Technology*, 21(3), 363-376.

the company's reputation from potential damage¹⁴¹. In this respect, an external whistle-blowing system is usually accompanied by damage to the reputation of the company with potential investors, potential employees and rating agencies. It is the obligation of the management board to prevent such damage within the framework of its general management task. In Germany there would only be an obligation, based on Section 93 of the AktG, if the advantages of anonymous whistle-blowing exceeded the detriments.

30. As far as conflict of whistle-blowing with substantive obligations is entailed, data protection law is perhaps the most challenging area. Conflicts can arise in a single jurisdiction, where compliance obligations faces limits imposed by the same country's data protection laws, but even more at cross-border level, where compliance-related information flows collide with one or more data protection regulations¹⁴². Unsurprisingly, some of the most interesting case-law originated from US compliance-related information gathering schemes and their conflict with the data protection laws of the host country of an affiliated company of US corporate group. More in-depth analysis will be provided in Part II (Chapter 6, par. 30) of this research, covering corporate groups.

¹⁴¹Pittroff, E. (2013). Whistle-Blowing Systems and Legitimacy Theory: A Study of the Motivation to Implement Whistle-Blowing Systems in German Organizations. *Journal of Business Ethics*, 1-14.

¹⁴²Gunasekara, G. (2007). The 'final' privacy frontier? Regulating trans-border data flows. *International Journal of Law and Information Technology*, 15(3), 362-393.

Chapter 12: Compliance and MiFID

31. So far, this research has dealt with the compliance obligations embedded in general law prescriptions, i.e. with the “*if*” question: is there such a thing as a compliance duty and, if so, what are its contents? Earlier in this research, it has been demonstrated that a duty of compliance does indeed exist for boardrooms, although usually some degree of discretion is granted to boardrooms as to *how* match this duty – the “*how*” question. Along with compliance duties deriving from general obligations, specific compliance duties for particular industries can derive from substantive laws, which also provide detailed prescriptions as to how compliance should be implemented.

32. Implementation of the MiFID (Markets in Financial Instruments) Directive¹⁴³ follows the “progressive levels” approach provided by the Lamfalussy procedure. The first level of the Lamfalussy process was reached with the approval of the 2004/39/CE Directive on markets in financial

¹⁴³ Council Directive 2004 /39/EC of the European Parliament and of the Council 21 April 2004 on markets in financial instruments, which amends Directives 85 /611/EEC and 93 /6/EEC of the Council and the Council Directive 2000/12/EC of the European Parliament and of the Council and repeals Council Directive 93 /22/EEC of the Council, and see the Directive 2006/73/EC of 10 August 2006 laying down detailed rules of implementation of Directive 2004/39/EC of the European Parliament and of the Council with regard to the requirements of organization and the activity terms for investment companies and the definitions of certain terms for the purposes of this Directive and Regulation (EC) No 1287/2006 of the Commission, 10 August 2006, laying down detailed rules of implementation of Directive 2004 /39/EC of the European Parliament and of the Council with regard to the obligations of investment firms to register, report the operations, work in a transparent market, use financial instruments during negotiations and define certain terms for the purpose of this Directive.

instruments (Level 1). This was completed with the enactment by the European Commission of the second level directive 2006/73/CE and EC regulation 1287/2006 (Level 2), both containing the detailed rules for the implementation of the first level directive: Directive 2006/73/CE, which refers to the requirements of the organization and the terms of use of the activity of investment companies. Following the creation of this regulation, and before January 2011, the Committee of European Securities Regulators (CESR) began the process of drawing up and disseminating interpretations, positioning and guidelines, and promotes the comparison between regulators, operators and relevant associations (Level 3). After January 2011, ESMA (European Securities and Market Authority) the new independent European authority continues the CESR plans.

Part II

Compliance in a cross-border corporate group

“Whoever operates in Italy – individual or corporate entity – has to respect Italian law. Here an administrative offense is imputed to a foreign corporation connected to a crime made in Italy. The jurisdiction is Italian, even if the corporation adopted a compliance program in a foreign context. If a corporation does not adopt a compliance program, it is not per se illegal. Its relevance is on the corporation’s culpability.”

Judge Mannocci, Siemens case¹⁴⁴

* * *

Chapter 1: Group Compliance in the pre-“Compliance Era” Case Law

0. As a preliminary remark, as acknowledged among others by a long scholarly debate, a corporate group as a conjunction of a number of companies does not have a legal status but only represent an economic unit, so the addressees of statutory provisions to be complied with are the **individual companies as separate legal persons**¹⁴⁵. This, however, does not mean that a parent company has no duties vis-à-vis the rest of the group¹⁴⁶ as explained

¹⁴⁴Trib. Milano, sez. XI Giud. Riesame, Pres. Rel. Mannocci, ord. 10-28-2004, Siemens, AG, as quoted in Bevilacqua, F.C. (November/December 2006). Corporate Compliance Programs Under Italian Law, *Ethikos and Corporate Conduct Quarterly*, , vol. 20 no. 3, 1.

¹⁴⁵Dewey, J. (1926). The historic background of corporate legal personality. *Yale Law Journal*, 655-673.

¹⁴⁶Grantham, R., & Rickett, C. E. (1998). *Corporate personality in the 20th Century*. Oxford: Hart Publishing.

more in-depth *infra*. With this in mind, the famous Supergun landmark case of 1996 can perhaps be mentioned as a lead case about compliance and cross-border corporate groups¹⁴⁷. Back in 1996, the Swiss criminal court condemned board members of a Swiss parent company (group holding) in a case where its subsidiaries violated arms control norms¹⁴⁸. Interestingly, the key argument upheld by the court was not that the board members of the parent company were culpable of illegal arms export, nor that they showed some sort of complicity with the group subsidiaries¹⁴⁹. Rather, the court held the parent company board responsible **for not having put in place a group-wide reporting and control system** that would have allowed the parent company's board to detect suspect behaviour at the level of subsidiaries. With a view to the above, the Supergun case can arguably be further un-packed into four key questions:

- i. Does the status of controlling/parent company within a corporate group entail specific compliance obligations for its board?
- ii. What are the contents and the scope of such obligations?
- iii. How are the obligations implemented group-wide?

¹⁴⁷Williamson Jr, R. L. (2003). Hard law, Soft law, and Non-Law in multilateral arms control: some compliance hypotheses. *Chi. J. Int'l L. - Chicago Journal of International Law*, 4, 59.

¹⁴⁸Scott, R. (1996). *Report of the Inquiry Into the Export of Defence Equipment and Dual-use Goods to Iraq and Related Prosecutions: Return to an Address of the Honourable the House of Commons Dated 15th February 1996*. House of Commons - Stationery Office, 5 Volumes and Index, Vol. 1.

¹⁴⁹Cassani, U. (2014). Corporate Responsibility and Compliance Programs in Switzerland. In Manacorda, S., Centonze, F., & Forti, G. (Eds.), *Preventing Corporate Corruption. Anti bribery compliance model*. Springer International Publishing, 491-503.

- iv. What are the limits imposed on group-wide compliance duties by legal obligations stemming from other law provisions affecting individual companies which are part of a group? If there are situations of two obligations imposed simultaneously, which obligation would rank senior?

Chapter 2: Cross-border complexity (Introductory Remarks)

1. As illustrated earlier in Part I of this research, compliance indisputably already poses critical challenges for single, stand-alone companies operating just in their home jurisdictions. The famous French statesman Charles De Gaulle famously asked *“How can you govern a country which has 246 varieties of cheese?”*. This witty sentence maintains much of its validity also in fields other than cheese: legal diversity – and complexity – are an inherent element of the global landscape, and pose great challenges to international corporate players. In a globalized corporate landscape, where suppliers and clients are all across the globe, the complexity – and the costs – of compliance challenges increases immensely. The expansion of the EU, the exponential growth of digital services, the rise of new market economies following the collapse of Soviet communism, and the opening up of China to foreign investment are just some of the better-known phenomena that have been experienced in recent years. How and to what extent do cross-border operations affect corporate compliance? Cross-border business, no doubt, *increases* the challenges of corporate compliance. Today, many of the markets targeted by “global”

corporate players are outside their “home” jurisdiction. A 2006 survey¹⁵⁰ by the Economist Intelligence Unit revealed that over one-third of survey respondents say they answer to ten or more regulators, and over three-quarters report to four or more. Siemens is a good example of this complexity: a global powerhouse with activities in nearly 190 regions, it has 336,000 employees working at 1,640 locations around the globe. A bank like Deutsche Bank¹⁵¹, operating in 74 countries, faces more than 350 regulatory exams a year. Moreover, today’s world is populated by corporate groups, rather than isolated business ventures. Management, too, is increasingly responsible for activities on an international basis. Its horizons are no longer limited by national or local considerations, but by “transnational” ones. With a view to corporate compliance, arguably one of the key challenges for compliance officers of internationally active companies is whether regulatory convergence will prevail, or divergence. In a November 2013 speech, Andrew Ceresney, Co-Director of the US SEC Division of Enforcement, noted that in 2013, the SEC, the US Department of Justice, and the US Federal Bureau of Investigation hosted a first of its kind Foreign Bribery and Corruption Training Conference¹⁵². Representatives from over 50 law enforcement and regulatory agencies from 30 different countries attended the conference during which the attendees shared

¹⁵⁰The Economist Intelligence Unit (June 2006). *Controlling risk and improving effectiveness*; Gladstein, D.L., & Reilly, N.P. (1985). Group decision-making under threat: the tycoon game. *Academy of Management Journal*, 23, 613–27.

¹⁵¹Bueschgen, H. E. (1995). Deutsche Bank from 1957 to the Present: The Emergence of an International Financial Conglomerate. In Gall, L. (Ed.), *The Deutsche Bank 1870-1995*. London: Weidenfeld & Nicholson.

¹⁵²The opening speech of the conference is available online at: <http://www.sec.gov/News/Speech/Detail/Speech/1365171492212#.VKgVK3te-6s>

information on enforcement and investigatory techniques, all with the goal of enhancing the enforcement of the (Foreign Corrupt Practices Act (FCPA) and other international anti-corruption laws. Moreover, enforcement agencies share their findings more often with their foreign peers, although substantial differences in approach still exist. Indeed, while it is commonly acknowledged that initiatives to foster greater cooperation among states are more common today than in the past, it is also true that the never-stopping production of new laws by different state actors inevitably results in greater complexity¹⁵³.

2. The concept of a company carrying on business in several countries is far from new. After all, the Dutch East India Company (the “Verenigde Oost-indische Compagnie”), founded in 1602, is often considered as the first true multinational corporation. From the 17th to the 18th century trading companies such as the Dutch East India Company (and its British counterpart, the East India Trading Company) acted on behalf of European governments in Asia. By 1750, the Dutch East India Company employed around 25,000 people and was doing business in 10 Asian countries¹⁵⁴.

3. Internazionalization has increased enormously in developing and transition economies in recent years. Current statistics convey an impressive message: according to the United Nation's World Investment Report of

¹⁵³According to a presentation by law firm Norton Rose, over the past two years the following states enacted new anti-corruption laws: Canada, Messico, Brazil, India, Ireland, Spain, India and Russia.

¹⁵⁴Wills, J.E. (1974). *Pepper, Guns, and Parleys: The Dutch East India Company and China*. Cambridge: Harvard University Press, 1622-1681.

2010: “[...] the global crisis has not halted the growing internationalization of production. The reduction in sales and in the value-added of foreign affiliates of transnational corporations in 2008 and 2009 was more limited than the contraction of the world economy. As a result, foreign affiliates’ share in global gross domestic product (GDP) reached an historic high of 11 per cent. Transnational corporations’ foreign employment increased slightly in 2009, to 80 million workers. The rise of developing and transition economies is apparent in international production patterns. These economies now host the majority of foreign affiliates’ labour force. In addition, they accounted for 28 per cent of the 82,000 transnational corporations worldwide in 2008, two percentage points higher than in 2006. This compares to a share of less than 10 per cent in 1992, and reflects their growing importance as home countries as well¹⁵⁵”.

4. Moreover, companies operating trans-nationally are often part of a corporate group or conglomerate¹⁵⁶, where they act either as parent/holding company or as subsidiaries¹⁵⁷. More specifically, “national” multinationals usually have a single parent company of a particular nationality, whilst “international” multinationals have two or more controlling parents of different

¹⁵⁵http://unctad.org/en/Docs/wir2010_en.pdf

¹⁵⁶Siedel, G. J. (2001). Legal complexity in cross-border subsidiary management. *Tex. Int'l LJ - Texas International Law Journal*, 36, 611.

¹⁵⁷Dunning, J. H. (1999). Trade, location of economic activity and the multinational enterprise: a search for an eclectic approach. In Buckley P.J., & Ghauri, P. (Eds.), *The internationalization of the firm*. London: Thomson, 61-79.

nationalities¹⁵⁸, but this description relates only to the legal structure and does not describe either the commercial activity of a group or the underlying decision-making structures¹⁵⁹. Arguably, limited liability is a crucial driver of corporate group architectures, because it becomes a matter of strategic policy how the firm is to be structured in a legal way. Incorporation does not only offer dispersed shareholders limited liability, but the regime is also available to a parent corporation that is sole shareholder in its incorporated subsidiaries – although as discussed *infra* this principle finds several exceptions. Limited liability provides the possibility to structure a firm as a corporate group¹⁶⁰. Groups are ubiquitous in the corporate landscape, as they provide two corporate architectural benefits to parents: first, with the decision of the parent company to incorporate each risky business¹⁶¹ in a separate corporation, it compartmentalizes the risks of each individual business into a subsidiary corporation¹⁶². With this, the individual subsidiary corporations could be shielded from damage claims that may arise from the activities of any of the other subsidiaries¹⁶³. Second, as a shareholder, the parent company needs not to

¹⁵⁸Bucley, P.J., & Casson, M.C. (1985). *The Economic Theory of the Multinational Enterprise*. London: Macmillan; Buckley, P.J., & Casson, M.C. (1976). *The Future of the Multinational Enterprise*. London: Macmillan.

¹⁵⁹Elango, B. (2004). Geographic Scope of Operations by Multinational Companies: An Exploratory Study of Regional and Global Strategies. *European Management Journal*, 22.4, 431-441.

¹⁶⁰McGee, J., & Thomas, H. (1986). Strategic groups: theory, research and taxonomy. *Strategic Management Journal*, 7.2, 141-160.

¹⁶¹Khanna, T., & Yafeh, Y. (2005). Business Groups and Risk Sharing around the World. *The Journal of Business*, 78.1, 301-340.

¹⁶²Sykes, A.O. (1984). The Economics of Vicarious Liability. *Yale Law Journal*, 93,1231.

¹⁶³Faccio, M., Lang, L., & Young, L. (2009). Pyramiding vs leverage in corporate groups: International evidence. *Journal of International Business Studies*, 41.1, 88-104.

provide additional capital in the case that one of its subsidiaries is confronted with a damage claim that more than erases all of the equity of the subsidiary. Given the fact that limited liability compartmentalizes subsidiary risk and protects the parent, it affects the way in which the parent chooses to control her subsidiaries. Compartmentalization makes it less necessary to control risks on the parent level as it will be in the case of one corporation. It is even the other way around: risky activities will be stimulated, because limited liability insulates the other subsidiaries and the parent¹⁶⁴¹⁶⁵. In a corporate group the result is a higher level of investment in risky activities in subsidiary corporations than in the unincorporated group¹⁶⁶. Limited liability affects the allocation of decision rights between parent and subsidiary¹⁶⁷. If the parent compartmentalizes business risks in corporate subsidiaries, it will not matter to her from a liability perspective whether decision rights stay at the level of the subsidiary board or will be brought to lower levels within the subsidiary corporations. To the parent it will not matter at what level in the subsidiary corporation a tortuous act is committed. In the absence of strong compliance prescriptions, although liability may flow upwards via a vicarious liability rule, it would halt at the level of the board of the subsidiary. As a matter of fact, corporate groups have the possibility to deploy different economic functions in

¹⁶⁴Easterbrook, F.H., & Fischel, D.R. (1985). Limited liability and the corporation. *U. Chi. L. Rev. - University of Chicago Law Review*, 52, 89.

¹⁶⁵Blumberg, P. (1993). *The multinational challenge to corporation law: the search for a new corporate personality*. New York: Oxford University Press.

¹⁶⁶ Glynn, T.P. (2004). Beyond "Unlimiting" Shareholder Liability: Vicarious Tort Liability for Corporate Officers. *Vanderbilt Law Review*, 57, 329.

¹⁶⁷ Brooks, R. R.W. (2002). Liability and Organizational Choice. *Journal of Law and Economics*, 45, 91.

a variety of jurisdictions. Cash management functions can be concentrated in one specific country, whereas intellectual property assets (patents, copyrights, trademarks, etc...) in another one, and so on. The services rendered by these “specialized” companies to the group are rolled over to other group companies through ad hoc service agreements. Furthermore, several group companies may be located in parts of the world where the potential size of the market may not even be matched by well-developed legal infrastructure.

5. The use of group structures and cross-border activity amplify the level of complexity of the global corporate landscape, as different countries very often have their own different rules, sophistication levels or pace of reform¹⁶⁸. Thus, the question arises whether the set of legal duties imposed in a specific jurisdiction is limited only to the relevant company or should be observed group-wide¹⁶⁹. In Germany, for instance, there have recently been two antitrust law cases, in which it has been discussed whether a foreign parent company is subject to a duty to install organisational measures within the German subsidiary companies¹⁷⁰.

¹⁶⁸Chandler, A.D., & Mazlish, B.(2005). *Leviathans: Multinational corporations and the new global history*. Cambridge: Cambridge University Press.

¹⁶⁹Teubner, G., & Sugarman, D. (1990). *Unitas Multiplex: Corporate Governance in Group Enterprises*. In Teubner, G., & Sugarman, D. (Eds.). *Regulating Corporate Groups in Europe*. Baden Baden: Nomos.

¹⁷⁰Bundeskartellamt, Az. B1-200/06 from 9 February 2009; ECJ, 10 September 2009 - C-97/08P ¼ (2009) 9 WM 2048 et seq with an annotation by Schneider, U.H. (December 8, 2009). Compliance im Konzern. *NZG - Neue Zeitschrift für Gesellschaftsrecht*, 34, 1321 and foll..

Chapter 3: Group-wide compliance as part of a group-wide management duty?

6. In this chapter, the issue will be examined whether there is such a thing as a group-wide duty of compliance, and, if so whether this duty is part of a group management duty. In fact, earlier in this research, we have ascertained for the stand-alone that the duty of compliance is part of a duty imposed on the board. Now, as we do not deal with a stand-alone company but with corporate groups, we set out to examine whether an analogy is possible. First, it should be defined what the *management duty* (in Germany this would be the “*Leitungspflicht*”, in Italy it would be the “*principio di corretta amministrazione*” enshrined in the Italian Civil Code) looks like. Although the group management duty¹⁷¹ is not defined explicitly, the tendency to infer the existence of a group-wide management duty from the peculiar nature of the group holding/parent company arguably represents a key element in the whole discussion about compliance within corporate groups.

7. First, it should be noted that the parent company – especially if its sole or predominant business is to manage its subsidiaries – carries out its business through the affiliated companies, and therefore in the German scholarly debate its board’s management duty can be deemed to include affiliated companies as well¹⁷². However, as we will point out more-in-depth *infra*, extrapolating the

¹⁷¹Kropff, B. (1984). Zur Konzernleitungspflicht. *Zeitschrift für Unternehmens- und Gesellschaftsrecht*, 13(1), 112-133.

¹⁷²Schneider, U.H., & Schneider, S.H. (2007). Konzern-Compliance als Aufgabe der Konzernleitung. *ZIP - Zeitschrift für Wirtschaftsrecht*, 44, 2063.

existence of a group management duty from the fact that a parent company acts through its affiliated company is not always accepted as a valid reasoning, and the Italian Supreme Court requires further elements to hold the parent company liable for the group.

8. Second, depending on the actual relationship between the parent company and its subsidiaries, further elements can be put forward to demonstrate the existence of a management duty of the former vis-à-vis the latter companies. For instance, to the extent a parent company does not just set high-level guidelines and does not leave the management of the subsidiaries to the subsidiaries' board and management, the parent company can be considered a "de facto director"¹⁷³. Pursuant to Italian criminal case law, the de facto director is equivalent to the rightful director and therefore is fully subject to the prohibitions and penalties provided by criminal law for the acts committed by both. Not applying these prohibitions would lead to a legal asymmetry, i.e. to considering that the criminally illicit activity by the de facto director is not an offence due to the absence of investiture in the position, unlike that existing in the rightful director and therefore the former would be unjustly exonerated of any criminal liability. The dominant Italian case law subjects the de facto director to criminal law in its substantial content and correctly deems that in criminal law, the liability is based on the effective management of the company which prevails over the formal one of taking on

¹⁷³Sgubbi, F. (2006). Gruppo societario e responsabilità delle persone giuridiche ai sensi del D. Lgs. n. 231/2001. *Rivista* 231, 1,7.

the office¹⁷⁴. The individual model fact situations of offences are configured by criminal law, regardless of the formal title, under which the activity of director is exercised but according to the factual observation that the activity is concretely exercised. Following this line of reasoning: because compliance duty is a duty ultimately imposed on the board, as discussed earlier in this research, then the compliance duty also applies to the parent company. Resorting to de facto directorship as a means to project a management duty (that includes a compliance duty) onto the whole group, may however prove difficult. In fact, in Italy, using a “de facto director” legal characterization can mean that a whole company (the parent company) is treated like a board director, i.e. that it is regarded as an individual regardless of its status of legal person. This shift of legal personality is not accepted in several legal traditions such as the English, as it entails substantial inroads into the long established principle that “although a company is an artificial entity and can only act through natural

¹⁷⁴Court of Criminal Cassation, 14th May 1993, defendant Delle Fave; Court of Criminal Cassation December 29th, 1972, defendant Zito in *Giust. pen.*, 1973, II, 591; Court of Criminal Cassation December 5th, 1966, defendant Savoldo in *Dir. fall.*, 1967, II, 974; Criminal Cassation May 8th, 1964, defendant Esposito in *Rep. Foro it.*, 1965, entry Società no. 220, 223, Criminal Cassation July 1st, 1963, defendant De Angelis in *Rep. Foro it.*, 1954, 246. In legal literature: Antolisei, F. (1959). *Manuale di diritto penale. Leggi complementari. I reati fallimentari*. Milano: Giuffrè Editore, 109; Zuccalà, G. (1954). *Il delitto di false comunicazioni sociali*. Padova: CEDAM, 53; Conti, L., & Bruti Liberati, E. (1971). *Esercizio di fatto dei poteri di amministrazione e responsabilità penali nell'ambito delle società irregolari. Il diritto penale nelle società commerciali*. Milano: Giuffrè Editore, 110 and foll.; Monelli, F. (1984). La responsabilità dell'amministratore di fatto. *Giurisprudenza commerciale*, 107; Abriani, N. (1988). *Gli amministratori di fatto delle società di capitali*. Milano: Giuffrè Editore, 200 and foll..

persons, it is to be treated as a legal personality separate and distinct from its directors and members”¹⁷⁵.

9. It may also be possible to argue that a group management duty exists if the holding company and its subsidiaries have the same board members (so called “interlocking directorates”). If, for instance, a subsidiary conducts a different business than the parent company but has the same board members of the parent, then it is safe to assume that there is an actual flow of information and directives between the parent company and the subsidiary. The existence of similar/identical corporate governance bodies, as well as the constant flow of information represent robust arguments to state the existence of management duties that extend well beyond the parent company and include the subsidiary. Paradoxically, also the choice as to how to organize and staff the compliance function group-wide can affect the qualification of a group wide management duty. In the Italian scholarly debate, most guidelines emphasize that the compliance function of group subsidiaries should avoid duplications with the parent’s compliance function, because in a litigation scenario the absence of duplications would make it more difficult to blame mis-compliance cases onto the whole group¹⁷⁶.

¹⁷⁵UK Supreme Court judgment in *Holland v Revenue and Customs (HMRC)* [2010] .

¹⁷⁶Opinion no. 1250 of the Italian Banking Association of April 19, 2011, available on-line: http://www.ilsole24ore.com/pdf2010/SoleOnLine5/Oggetti_Correlati/Documenti/Norme%20e%20Tributi/2011/10/guida-reati-ambientali/Parere-ABI-OdV.pdf.

10. With a view to the question raised in the previous paragraph, one should recall at the outset that, although the corporate group is an economic unit, this does not mean that each company shares the same interest. This may, for instance, have to do with the fact that each group company is tasked with a different business and thus has different goals and priorities. Moreover, the **self-interest of the parent company** can be quite different from the **subsidiaries' interest**¹⁷⁷. This is for instance quite evident in taxation matters, as the use of cross-border group structures often magnifies the potential to "optimize" revenue flows within the group, and achieve substantial tax savings by allocating higher portions of group revenue to group companies that are incorporated in jurisdictions with a limited tax burden. Many legislators are aware of different interests coexisting in the same group, and have thus foreseen a duty for the parent company to prevent damage to subsidiaries (or, if damage occurs, to restore it or compensate the damaged company). For instance, art. 2497 of the Italian Civil Code recognizes the legitimacy of management and coordination as well as the "physiological" interference of the holding company (parent) in the management of the companies belonging to its group. The obligation of proper management is binding for each company or entity exercising management and coordination, including not only the directors of the holding and the controlled company, but also the holding company itself. As a consequence, in case of damage, such entities will be deemed liable as well as, more generally, any person having taken part in the

¹⁷⁷Montalenti, P. (1995). Conflitto di interesse nei gruppi di società e teoria dei vantaggi compensativi. *Rivista delle Società. Atti del Convegno Internazionale di Studi*, 16-17.

harmful act. Any damage is to be evaluated in the context of the economic and business interests of the group as a whole, and taking into account the overall results of the management and coordination acts on the basis of an after-the-fact inquiry, including both the damages and benefits affecting the company subject to management and coordination¹⁷⁸.

11. The duty of the parent company to prevent damage strongly commends the establishment of a compliance system across the group, which is organisationally embodied within the parent company. In fact, in the previous paragraphs, we have examined a variety of elements that are used in the scholarly debate and legal discourse to argue in favour of or against the existence of a group-wide compliance duty. These elements are mostly centered around the peculiar nature of the parent company: the holding (and management) of the subsidiaries, the potential re-characterization of the holding as de facto director, the one-enterprise approach used in some jurisdictions (such as the Swiss) and specific legal branches (e.g. EU competition law). In addition to these elements, one can also recall the almost universal principle of organizational appropriateness, i.e. the idea that compliance is a commensurate duty. While there is no doubt that there is such a thing as a compliance obligation and that this obligation lies with the top management of a firm, it is also true that the extent to which this obligation has to be satisfied depends on the complexity and nature of the firm itself. For instance, in the

¹⁷⁸Roth, K., & O'Donnell, S. (1996). Foreign subsidiary compensation strategy: An agency theory perspective. *Academy of management Journal*, 39(3), 678-703.

words of the ISO 19600 standard on compliance systems management (par. 4.6): “The organization should document its compliance obligations in a manner that is appropriate to its size, complexity, structure and operations” and “the extent and level of detail of the compliance risk assessment are dependent on the risk situation, context, size and objectives of the organization and can vary for specific sub-areas (e.g. environment, financial, social)”. Also in the recent Neuburger judgement by the Munich Regional Court, the court acknowledged that:

- i. a board member fulfills its organizational duty in case of a corresponding potential threat only if he/she establishes a compliance system aimed at risk control and damage prevention;
- ii. the company’s type, size and organization, the provisions to be complied with, the geographical presence as well as suspected cases in the past are crucial for the extent of the compliance system in detail.

Hence, if one accepts that corporate groups often entail greater complexity, then it should be possible to maintain that there is such a thing as a group management duty, and that this duty is commensurate to the greater complexity of group architectures.

12. In this paragraph, the different types of linkages between the parent company and its subsidiaries will be examined for the purpose of compliance. In fact, the argument that each company should be considered singularly (the

“archipelago solution” or “*Inselloesung*”¹⁷⁹) when analysing organizational duties is a simplistic argument, and partly fails to recognize the findings of criminal law debate. For instance, in cases of bribery at the controlled company level, it is always necessary to look at the possibility of the controlling company being (concurrently) liable. There are various forms of establishing this liability. For the sake of this research, we will mention three basic paradigms: direct liability, agent liability and one-enterprise liability. Under the “Direct liability” paradigm, where the controlling company participated directly in the bribery of the controlled company. For example, by either instigating the misconduct or by approving payments to a third-party used as a bribe. In the Italian criminal law debate, it is commonly held that it is important to verify whether the individual who actually commits a crime has an executive status or a non-executive status in both the parent company and the subsidiary. If the author of the crime holds positions in both companies, it should be assessed in what capacity he acted when committing the crime. This distinction is however impossible if the author of the crime is an executive with executive powers in the power as well as in the subsidiary, because this would entail a functional link between the individual who commits the crime and the company for both companies. In the “direct liability” cases, the controlling company will be directly liable either for the acts of its senior management, its employees - or for a lack of supervision. Pursuant to a landmark judgement by the Italian Supreme Criminal Court (Corte di Cassazione - sezione penale) of January 29 2013, no.

¹⁷⁹Schneider, U.H., & Schneider, S.H. (2007). Konzern-Compliance als Aufgabe der Konzernleitung. *ZIP - Zeitschrift für Wirtschaftsrecht*, 44, 2063.

4324, the parent company can be held liable if the individual who violated the law did so also by also pursuing an interest of the parent company – regardless of formal agreements with the subsidiary. If “Agent liability” is involved, the controlling company is responsible for acts of the controlled company as its agent. Lastly, under the “one enterprise liability” concept, the owner of several legal persons is regarded itself as one enterprise encompassing and making use of all legal persons. Thus, any bribery within this one enterprise renders it liable either by imputation or by lack of supervision as if the bribery happened not in a separate legal person but within one enterprise. In the Swiss Criminal Code for example, the offence “is attributed to the undertaking” (a synonym for “enterprise”)¹⁸⁰. If several companies are combined under a holding company, the holding company can be viewed as one single enterprise comprising all companies. In such case, an offence taking place in one of the companies can be viewed as having taken place in the one enterprise: the holding company. Under Italian law, pursuant to art. 5 of legislative decree no. 231/2001, in order to detect which company within a corporate group shall be held accountable for miscompliance, the specific interest or benefit of an entity has to be ascertained first. The interest can be: **a)** the interest of both the parent company and the subsidiary, **b)** the sole interest of the parent company, **c)** a more comprehensive and collective type of interest – a group interest. More specifically, in its judgement no. 9/2011, the Italian Supreme Court (Corte di Cassazione) stated that, in order to hold a parent company or another group company liable, it is

¹⁸⁰Swiss Legislation “SR 311.0”, as of January 1st, 2013, available on-line at: http://www.admin.ch/ch/e/rs/311_0/a102.html.

necessary that an individual who acts on behalf of the parent company or another group company concurs to the the crime. This linkage means that the liability of a group company does not automatically and per se result in an extension of the liability to other group companies, unless executives or employees concurred to the crime. This echoes a landmark opinion by the Italian State Council¹⁸¹, according to which *“because the corporate liability is correlated to a deficiency of the organizational and oversight systems used by the specific company whose executives or employees committed the crime, i.e. to objective elements of a company, it should be excluded that, in the case of crimes committed at the level of a group company, the sanctions [...] can be extended to all the group companies”*. This is very important, because it suggests that in Italy the “one-enterprise liability” theory cannot be used automatically, but that the existence of a “group-wide liability” shall be proved on a case-by-case basis¹⁸². More specifically, according to the Italian Supreme Court, the will to commit a crime by the holding company must be proved, and the benefits (i.e. the enrichment) of the holding company must be proved, too. Therefore, in principle, the parent company can be held liable only when it does more than merely engage in holding stakes, and actively engages in business conduct, also via the interposition of other persons. At EU level, competition authorities do not allow for any defence in the form of proof that appropriate antitrust compliance

¹⁸¹Italian State Council, section III, January 11th, 2005.

¹⁸²See also Italian Supreme Criminal Court judgment no. 24583 of June 20th, 2011.

programmes had been implemented.¹⁸³ Instead, the Commission concludes from the fact that an infringement of competition law took place that there *must* be a guilty party. Given that the individual involved in the cartel cannot be held liable for lack of a legal basis in EU antitrust law, the responsibility is, by default, attributed exclusively to the relevant undertaking. This logic as applied by the Commission can be clearly seen from, e.g., the following statement: *“In general, while the Commission welcomes measures taken by undertakings to avoid cartel infringements, such measures cannot change the reality that infringements did take place and the need to sanction them in this Decision”*¹⁸⁴. Based on the argument that the existence of a compliance programme did not prevent the infringement from taking place, the Commission also refuses to take such programmes into account as a mitigating factor. In the “British Sugar” case¹⁸⁵, the Commission even regarded the existence of a compliance programme as an aggravating circumstance¹⁸⁶.

12. In a group it is commonly accepted that the dominance of one entity can result into a damage inflicted by the dominant entity to the other group entities, but this damage has to be compensated. Moreover, attention should be paid to the design of the group. The most obvious example is the parent-subsidiary relationship. Other forms include one company controlling another one

¹⁸³Hofstetter, K., & Ludescher, M. (2010). Fines Against Parent Companies in EU Antitrust Law-Setting Incentives for 'Best Practice Compliance. *World Competition: Law and Economics Review*, 33 (1).

¹⁸⁴Commission, 21.2.2007, PO/Elevators and Escalators, E-1/38.823, margin no. 631.

¹⁸⁵Commission, 14.10.1998, British Sugar Plc, OJ of March 22, 1999, L 76/1, margin no. 208

¹⁸⁶Stephan, A. (2009). Hear no evil, see no evil: why antitrust compliance programmes may be ineffective at preventing cartels. *CCP Working Paper*, 09-9.

through formal agreements on control or on transfer of loss and profits. Control can also take place as a de facto control if both companies are managed by the same persons, or if one company is economically fully dependent on the other. In Germany, there are formal agreements on control or on transfer of loss and profits are explicitly foreseen by the law (*Beherrschungsvertrag*). In Italy it is debated whether the *Beherrschungsvertrag* is admitted in other jurisdictions, and Italian doctrine seems to agree that only the “light” *Beherrschungsvertrag* is legally admitted in Italy, but no such an agreement that empties the controlled/affiliated company of its legal prerogatives¹⁸⁷. Further on this note, it is important to note that several comments in the Italian doctrine suggest that a different kind of infra-group agreement should in any case be explicitly stipulated also to regulate group-wide compliance. More specifically, it is suggested that the parent company submits to all of its subsidiary a contract in which the guiding principles for compliance are provided – often in the form of a group-wide code of ethics¹⁸⁸. In Germany, characterising for a group governed by contract is that the parent company legitimates their domination (or control) of the affiliated companies by one of the company contracts, mentioned in Sections 291 et seq of the AktG, which also contain defence instruments for the controlled company. As a consequence, in the group by

¹⁸⁷Picione, A. D. L. (2008). *Operazioni finanziarie nell'attività di direzione e coordinamento*. Milano: Giuffrè Editore, Vol. 321.

¹⁸⁸Previtali, P. (2009). *Modelli organizzativi e compliance aziendale. L'applicazione del D. Lgs. 231/2001 nelle imprese italiane*. Milano: Giuffrè Editore, Vol. 57; Lancellotti, G., & Lancellotti, F. (2011). *Il modello di organizzazione, gestione e controllo ex D. lgs. 8 giugno 2001, n. 231. Uno scudo processuale per le società e gli enti*. Torino: Giappichelli Editore.

contract, economically unfavourable instructions are allowed¹⁸⁹, as they have to be automatically compensated by the parent company by the end of a year¹⁹⁰. However, the instructions have to be given to the respective management board of the affiliate and not directly to the individual employees of the affiliate. An exception is only possible if the supervisory board of the affiliated company has delegated its own authority to instruct to the parent's compliance department of the group¹⁹¹.

13. Groups can also exist as “de facto” groups. In this particular design, because a contract, legitimating the domination, is absent, the detection of the group can sometimes be complex. Economically unfavourable instructions are only allowed, if the disadvantage will be compensated in each particular case¹⁹². Thus, the focus shifts to the question under what circumstances an instruction is detrimental (unfavourable). If the example above is considered again, in which the dominant company instructs the dominated company to end potentially illegal conduct, which has an economically profitable effect for the affiliate, the question arises, whether the disadvantage has to be determined solely under economic or also under other considerations. Under Italian law (art. 2497 and

¹⁸⁹Hofstetter, K. (1990). Parent Responsibility for Subsidiary Corporations: Evaluating European Trends. *International and Comparative Law Quarterly*, 39(03), 580.

¹⁹⁰Casper, M. (2012). Corporate Governance and Corporate Compliance. In Du Plessis, J.J., Großfeld, B., Luttermann, C., Saenger, I., Sandrock, O., & Casper, M. (Eds.), *German Corporate Governance. International and European Context*. Berlin-Heidelberg: Springer, 388.

¹⁹¹Fleischer, H. (2008). Corporate Compliance im aktienrechtlichen Unternehmensverbund. *CCZ - Corporate Compliance Zeitschrift*, 1, 6.

¹⁹²Fasciani, P. (2007). Groups of companies: the Italian approach. *European Company and Financial Law Review*, 4(2), 220.

seq. of the Italian Civil Code), the existence of a detriment shall be assessed not only based on a mere economic/accounting criterion, but on a normative concept as well.

14. In the context of globally active corporate groups it is also important to underline that many day-by-day functions can be outsourced, i.e. transferred to external entities which are not part of the corporate group. According to the newly released ISO 19600 standard (par. 3, “Outsourced processes”) *“the organization should ensure that outsourced processes are controlled and monitored. Outsourcing of an organization’s operations usually does not relieve the organization of its legal responsibilities or compliance obligations. If there is any outsourcing of the organization’s activities, the organization needs to undertake effective due diligence to ensure that its standards and commitment to compliance will not be lowered. Controls over contractors should also be in place to ensure that the contract is complied with effectively (e.g. third-party performance appraisals). The organization should consider compliance risks related to other third-party-related processes, such as supply of goods and services and distribution of products, and put controls in place, as necessary (e.g. compliance obligations in contractual clauses)”*. Indeed, it is possible to argue that private-to-private (P2P) compliance may create additional complexity for companies. Program elements and ethical policies become contractual obligations, vulnerable to such contractual remedies as indemnities, damages, audits, default declarations, loan acceleration and termination. P2P compliance is reshaping the compliance task portfolio and raising new questions about who is answerable to whom, both internally and across company boundaries.

Private compliance pressures may originate from any point in the value chain: suppliers, customers, capital markets, insurers¹⁹³.

15. As discussed earlier in this research, there is a tendency in legislation not to specify too much how the compliance obligation should be fulfilled. On the one hand, this certainly reflects the virtually limitless spectrum of solutions and combinations offered by corporate law and operational needs, and respects the discretion of the group management about the allocation of roles and functions within the group companies¹⁹⁴. On the other hand, this is also a reminder that compliance duty is inherently an *internal* obligation, i.e. an obligation that cannot be upheld by third parties against a company or a group. In this respect, The German Federal Court of Justice (BGH) recently dealt in a competition law matter with the reach of the organizational duties of a managing director of a German limited liability company with respect to external third parties¹⁹⁵. In the case at stake, the plaintiff had filed an action against both a German limited liability company and its managing director because in its opinion the managing director was also personally liable to it in addition to the company. The German Federal Court of Justice (BGH) clarified that the organizational duties of a managing director only exist in principle with respect to the company, but not with respect to external third parties. According to the court,

¹⁹³Killingsworth, S. (2014). The Privatization of Compliance. *RAND Center for Corporate Ethics and Governance Symposium White Paper Series, Symposium on "Transforming Compliance: Emerging Paradigms for Boards, Management, Compliance Officers, and Government"*.

¹⁹⁴Daccò, A., & Portale, G. B. (2006). Accentramento di funzioni e di servizi nel gruppo e ruolo dell'assemblea della società controllata. *Rivista di diritto privato*, 11(3), 463-483.

¹⁹⁵Judgement of 18.06.2014, file no. I ZR 242/12

a personal liability with respect to third parties due to a breach of organizational duties only comes in consideration in exceptional cases¹⁹⁶. This could, for example, be the case if the managing director ignores breaches of which he is aware or prevents himself from obtaining knowledge of such. The same applies if the managing director has himself established a business model aiming at the infringement of rights. However, if managers culpably breach their organizational duties to the company, they may be liable to pay damages to the company. Moreover, the creditors of the company in each case may then be able to enforce a claim against the managing director by if they prove that an asset of the company has been damaged. Under Italian law, pursuant to art. 2403 of the Italian Civil Code, the director has to ensure that the company has an appropriate organization. Failure to do so is generally regarded as an important element that creditors can use to hold the director accountable in case of a damage to the company's wealth. Moreover, in 2007 art. 2428 of the Italian Civil Code - the article that defines the mandatory contents of the financial statement's management explanatory notes ("*Relazione sulla gestione*") was amended to include a list of potential risk areas¹⁹⁷. Hence creditors shall back up potential lawsuits against corporate directors or statutory auditors not

¹⁹⁶Grüninger, S., Jantz, M., Schweikert, C., & Steinmeyer, R. (2012). Organisationspflichten-eine Synopse zum Begriffsverständnis und den daraus abzuleitenden Anforderungen an Aufsichts-und Sorgfaltspflichten aus juristischer und betriebswirtschaftlicher Perspektive.Studie 2 im Forschungsprojekt "Leitlinien für das Management von Organisations-und Aufsichtspflichten".KICG-Konstanz Institut Für Corporate Governance Forschungspapiere, No. 4.

¹⁹⁷Ginesti, G. (2014). *La relazione degli amministratori nella comunicazione economico-finanziaria d'impresa: Profili teorici e prassi internazionale*. Torino: Giappichelli Editore.

merely with allegations about a lack of organization, but also with allegations about a lack of *risk disclosure*¹⁹⁸.

Chapter 4: Group-wide compliance organization within the group

15. As pointed out earlier, when examining compliance, the main focus of scholarly research is the “if” question, i.e. whether a duty of compliance exists and whether it contains a specific obligation. However, when it comes to the “how” question – how should compliance be organized? How should a compliance department be set up? – there are few specific indications provided by the law. In Germany, also the GCGC (Article 4.1.3) does not provide any specific guidance as to *how* the compliance system should be organized within a group, i.e. whether it is only required at the level of the parent company or whether a more granular group-wide organization is necessary. In fact, Art. 4.1.3 goes as follows: “*The Management Board ensures that all provisions of law and the enterprise’s internal policies are abided by and works to achieve their compliance by group companies (compliance).*” Thus, in this statement, a clear gradation is expressed: the management board faces a strong duty vis-à-vis the parent company, and a loose obligation vis-à-vis the rest of the group. In fact, while the management board has to **take over the responsibility** for the compliance with the statutory provisions within the parent company, it only has to **work towards** it in the affiliate companies. This means, at least indirectly, that the

¹⁹⁸Beretta, S., Bozzolan, S., & Michelon, G. (2011). La disclosure sul sistema di controllo interno come meccanismo di monitoraggio: evidenze empiriche da differenti contesti istituzionali. *Management Control*, 1, 125-150.

duty and the responsibility ultimately lie with the managing body of the affiliate companies.

16. In German doctrine, it is asked whether there are arguments under company law to assume a duty to establish a compliance department across the group, based on the duty to prevent damage. As in the single, stand-alone enterprise, the legal basis would be the general public duty of care of the managing directors towards their own company, pursuant to Section 130 OWiG according to which the owner of a company acts contrary to public policy if he or she omits to implement the necessary control measures required to prevent breaches of duty by the company, which are punishable by means of a fine or a sentence. However, Section 130 only applies to the “owner of a company”, and it is questionable whether the relationship among the parent/dominating company in a corporate group is the same as the relationship among the owner and the owned company. In fact, according to a December 1, 1981 BGH sentence¹⁹⁹, the legal personality of the affiliated company could not allow to consider the dominating company as the “owner” of the company. According to Casper, a general duty of the management board of the controlling company to ensure lawful conduct of the affiliated companies in the sense of a duty of group management cannot be acknowledged²⁰⁰²⁰¹. On the one hand, it is

¹⁹⁹Quoted by Schneider, U.H. (December 8th, 2009). Compliance im Konzern. *NZG - Neue Zeitschrift für Gesellschaftsrecht*, 34, 1324.

²⁰⁰ Casper, M. (2012). Corporate Governance and Corporate Compliance. In Du Plessis, J.J., Großfeld, B., Luttermann, C., Saenger, I., Sandrock, O., & Casper, M. (Eds.), *German Corporate Governance. International and European Context*. Berlin-Heidelberg: Springer, 387.

possible to maintain that the duty of group management cannot be derived from the status of the parent company as shareholder. In fact, the point of departure is the basic principle of corporate law that shareholders are not liable for the obligations of the corporation in which they hold ownership. This principle of the limited liability of corporations is, as such, to be honoured in any area of the law. In a corporate group, the responsibility of the various legal entities must therefore be clarified individually²⁰². On the other hand, it is also true that the parent company carries out its business also through affiliated companies, and therefore its own duty of management also represents a duty of group management²⁰³ based on the active management of the subsidiaries' business and not on the status of shareholder of the parent company.

17. The establishment of a compliance system seems to be in line with the US landmark case law on the duty of care, and, in particular with the *Caremark* case (see *infra*, Part I, Chapter 2, par. 10), as well as with general obligations such as to Section 130 OWiG according to which the owner of a company acts contrary to public policy if he or she omits to implement the necessary control measures required to prevent breaches of duty by the company, which are punishable by means of a fine or a sentence.

²⁰¹Verse, D. A. (2011). Compliance im Konzern, Zur Legalitätskontrollpflicht der Geschäftsleiter einer Konzernobergesellschaft. *ZHR - Zeitschrift für das gesamte handelsrecht und wirtschaftsrecht*, 175(2), 401-424.

²⁰²Hofstetter, K. (1995). *Sachgerechte Haftungsregeln für Multinationale Konzerne: Zur zivilrechtlichen Verantwortlichkeit von Muttergesellschaften im Kontext internationaler Märkte*. Tübingen: Mohr Siebeck, 77.

²⁰³Schneider, U.H. (December 8th, 2009). Compliance im Konzern. *NZG - Neue Zeitschrift für Gesellschaftsrecht*, 34, 1326.

18. Even if it is not necessarily possible to invoke a general obligation to monitor for corporate groups such as the one stipulated under Section 130 OWiG, it is nevertheless increasingly evident that international case law recognizes the duty for the dominating/parent company in a group to set up a group-wide compliance organization. We have already recalled the 1996 Swiss Supergun case, where the parent company's board were indicted not because they committed a crime, but because they did not set up a group-wide compliance organization²⁰⁴. Moreover, with the *Akzo*²⁰⁵ ECJ Judgement, the European Court of Justice has confirmed that parent companies are presumed to be liable for cartel infringements committed by a wholly owned subsidiary. The presumption is rebuttable, but parent companies are very unlikely to escape cartel fines by claiming their subsidiaries operate independently. In the *Etex Case* on February 9 2009 the Federal Antitrust Authority held that under Section 130 of the Administrative Offence Act a parent company can be fined if it omits to take appropriate measures to prevent its subsidiaries from forming a cartel with competitors²⁰⁶. The authority fined several producers of clay bricks that had agreed on a price increase, including two German subsidiaries of the Belgian ETEX group. An additional fine of more than €10 million was imposed on the German parent company, ETEX Holding GmbH, as it had not taken reasonable measures to prevent the participation of its subsidiaries in the cartel.

²⁰⁴Reich-Graefe, R. (2004). Changing Paradigms: The Liability of Corporate Groups in Germany. *Conn. L. Rev. - Connecticut Law Review*, 37, 785.

²⁰⁵Case C-550/07 P. *Akzo Nobel Chemicals Ltd v Commission*.

²⁰⁶Tschierschke, A. (2013). *Die Sanktionierung des Unternehmensverbundes: Bestandsaufnahme, Perspektiven und Europäisierung*. Baden - Baden: Nomos Verlagsgesellschaft.

According to this ruling even foreign parent companies may be held liable for the defective compliance organization of their German subsidiaries.

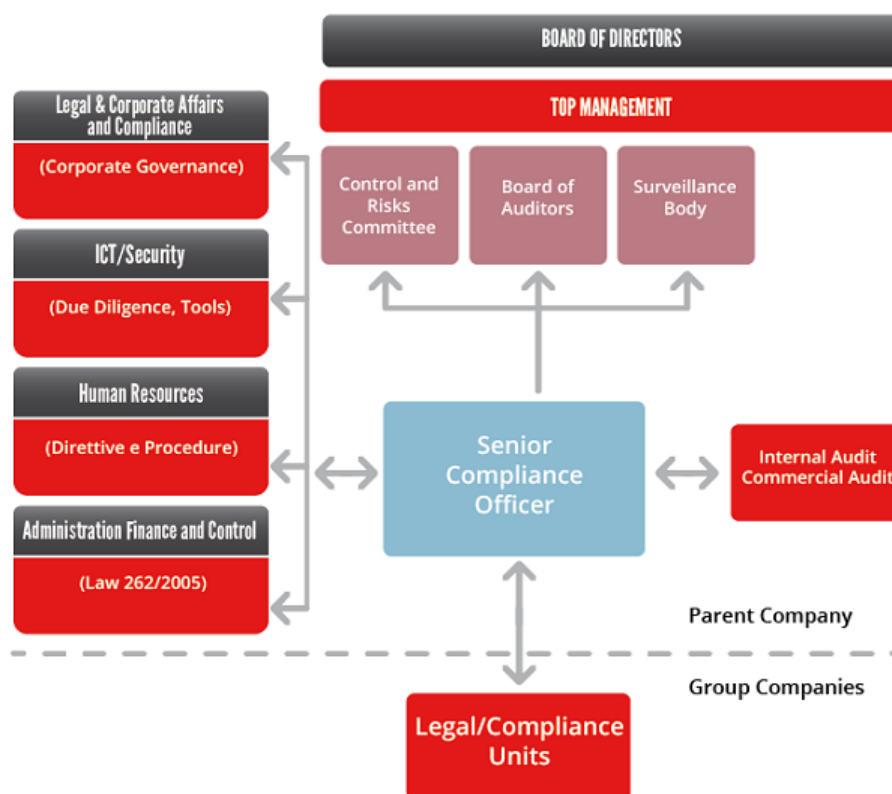
19. With a view to the organization of a compliance organization across the group, a broad discretionary power exists²⁰⁷. In particular, the management board of the parent company is entrusted with the organisational discretion. More specifically and it may meet its duty either with a strong, **central** compliance department or by means of many **decentralised compliance departments**²⁰⁸ in each affiliate company²⁰⁹, which are interlinked with each other. In the case of decentralized compliance, intermediate layers can be found as well, such as for example “**regional**” compliance functions, such as Europe, Middle-East and Asia (so called EMEA), whose purpose it is to act as organizational filters for the compliance processes managed by individual companies operating within a given region. Both solutions - centralized compliance management and decentralized management - are widely adopted. As an example of decentralized compliance management, the Italian state-owned defence and technology group Finmeccanica provides the following layout²¹⁰ of its group compliance structure:

²⁰⁷Pohland, S. (2000). *Globale Unternehmensarchitekturen. Methode zur Verteilung von Informationssystemen*. Berlin: Weißensee-Verlag.

²⁰⁸Gupta, A. K., & Govindarajan, V. (1991). Knowledge flows and the structure of control within multinational corporations. *Academy of management review*, 16(4), 768-792.

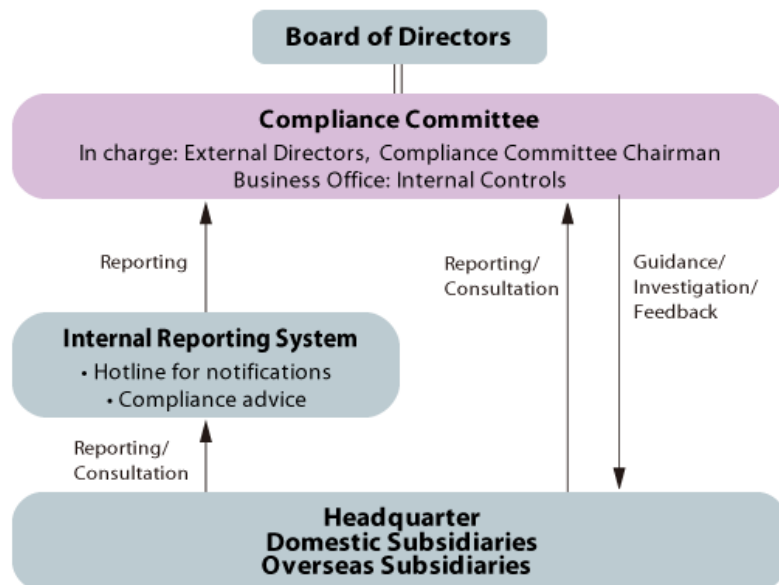
²⁰⁹Kleindiek, D. (2003). Konzernstrukturen und Corporate Governance: Leitung und Überwachung im dezentral organisierten Unternehmensverbund. In Hommelhoff, P. Hopt, K., v. Werder, A., *Leitung und Überwachung börsennotierter Unternehmen in der Rechts- und Wirtschaftspraxis*, 787.

²¹⁰www.finmeccanicagroup.com



An example of a centralized compliance model is the following layout by Japanese videogame leader CapCom²¹¹:

²¹¹<http://www.capcom.co.jp/ir/english/president/governance.html>



Therefore, the main overarching requirement is that responsibility for compliance within the group as a whole is established, whichever method is selected²¹². Additionally, compulsory guidelines across the group have to be defined. Moreover, a reporting system on possible breaches, including the monitoring of this reporting system, has to be established and the management board has to be enforced within the whole group²¹³. However, with regard to the actual particularities of the systems, generalising statements cannot be made, as the circumstances of the individual case in the respective group must be taken into account. In many cases, it can prove quite problematic – especially for small and medium sized corporate groups – to devise a compliance

²¹²Montalenti, P. (2009). Organismo di vigilanza 231 e gruppi di società. *Analisi Giuridica dell'Economia*, 8(2), 383-396.

²¹³Hauschka, C. E. (2006). Von Compliance zu Best Practice. *Zeitschrift für Rechtspolitik*, 39, 258-261.

management system that matches the compliance duty but represents no excessive burden for the group. In this respect, ISO 19600 can prove itself as a valuable tool. In fact the ISO 19600 standard is designed as a flexible guideline without any normative references. It provides recommendations based on the principles of good governance, flexibility, proportionality, transparency, and sustainability. It is open for all kind of organizations. Especially small and medium-sized companies benefit from this approach, as they can implement the guideline recommendations according to the size and maturity of their company²¹⁴. It is this kind of flexibility that gives small and medium-sized companies the incentive to deal with compliance on their own terms. Because the guideline is based upon the principle of continual improvement, organizations can expand their compliance management systems as their needs increase²¹⁵. Should the management board decide in favour of a strong, central compliance department at the level of the parent company, the management of the subsidiary companies is nevertheless not released from establishing its own compliance system if necessary. Moreover, other issues can arise. For instance, in the Italian scholarly debate about the status of the parent company's compliance function's team members²¹⁶²¹⁷, it is generally maintained that: a)

²¹⁴Bleker, S., & Hortensius, D. (2014). ISO 19600: The development of a global standard on compliance management. *Journal of Business Compliance*, 3(2), 48-59.

²¹⁵Almy, A. (2014). Why certify? The value of anticorruption compliance program certification. *Journal of Business Compliance*, 3(3), 43-51.

²¹⁶See the Confindustria (the Italian industrialists' umbrella organization) guidelines available online at: www.confindustria.it; alternatively, in German language, see: Kuhlmann, P. (2014). *Verbandssanktionierung in Italien: Das decreto legislativo 8 giugno 2001 n. 231 im Vergleich mit europäischen Vorgaben und dem deutschen Recht*. Munchen: Herbert Utz Verlag (Vol. 795).

when working on other group companies other than the parent company, the parent company's compliance function members should be regarded as external service providers/consultants rendering services to the subsidiaries, b) in this consultant status, the confidentiality obligations routinely applicable to professionals apply. This is especially important if one bears in mind that a number of legal concepts protect communications between a client and his or her attorney and keeps those communications confidential. In the U.S., for example, the attorney-client privilege is one of the oldest recognized privileges for confidential communications, and that the U.S. Supreme Court has stated that by assuring confidentiality, the privilege encourages clients to make full and frank disclosures to their attorneys, who are then better able to provide candid advice and effective representation²¹⁸. Should this be the case, situations can take place in which there is a conflict for the parent company's compliance function members. More precisely: to what extent is it possible to reconcile these members' obligation vis-à-vis the parent company and the confidentiality obligations stemming from the "consultant status" vis-à-vis the group subsidiaries? Further operational complexity can be envisaged for those cases in which compliance functions are not assigned to a department of the parent

²¹⁷Mazzacuva, F. (2014). *L'ente collettivo come soggetto nell'ambito del diritto punitivo: modelli di responsabilità e nuovi strumenti sanzionatori. Analisi comparata con i sistemi di common law*. Doctoral dissertation. Milano: Università degli Studi di Milano-Bicocca.

²¹⁸Nelson, C. E. (2014). Corporate Compliance Monitors Are Not Superheroes with Unrestrained Power: A Call for Increased Oversight and Ethical Reform. *Geo. J. Legal Ethics -Georgetown Journal of Legal Ethics*, 27, 723-1021.

company, but to an “insourced”²¹⁹ group company whose sole/primary purpose is to provide compliance management services to the whole group²²⁰.

20. Having said this, it is also very important to understand *who* is actually in charge of compliance. Assigning responsibility for compliance within an organization is a particularly important part of the ISO 19600 standard. More specifically, pursuant to par. 5.3.2 (*“Assigning responsibility for compliance in the organization”*), *“the active involvement of, and supervision by, governing body and top management is an integral part of an effective compliance management system. This helps ensure that employees fully understand the organization’s policy and operational procedures and how these apply to their jobs, and that they carry out compliance obligations effectively. For a compliance management system to be effective the governing body and top management need to lead by example, by adhering to and actively supporting compliance and the compliance management system. Many organizations have a dedicated person (e.g. a compliance officer) responsible for day-to-day compliance management, and some have a cross-functional compliance committee to coordinate compliance across the organization. Some organizations – depending on their size –also have someone who has overall responsibility for compliance management, although this may be in addition to other roles or functions, including existing committees, organizational unit(s), or outsource elements to compliance experts. This should not be seen as absolving other levels of management of their*

²¹⁹Mauermair, J. (2013). *Compliance and Supply Chain Safety. Supply Chain Safety Management*. Berlin – Heidelberg: Springer, 299-308.

²²⁰Schniederjans, M. J., & Zuckweiler, K. M. (2004). A quantitative approach to the outsourcing-insourcing decision in an international context. *Management Decision*, 42(8), 974-986.

compliance responsibilities, as all managers have a role to play with respect to the compliance management system. It is therefore important that their respective responsibilities are clearly set out and included in their job descriptions. Compliance responsibilities of managers will, by necessity, vary according to levels of authority, influence and other factors, such as the nature and size of the organization. However, some responsibilities are likely to be common across a variety of organizations". In this respect, in the recent Neubuerger judgement by the Regional Court of Munich²²¹, Mr. Neubuerger, a former Siemens board member, defended himself against the claim for damage inter alia on the ground that the compliance system was not part of the board department under his responsibility. He had adopted for his department corresponding directives to prevent dubious payments. Division managers were responsible for the practical implementation. According to the Court, however, depending on the company's type and risk situation the board is obligated to create a clear responsibility for compliance within the board. The departmental responsibility of one board member does not, however, release the (remaining) board members of their overall responsibility to ensure the observance of the principles of legality. All board members are obligated to clarify reported infringements, to keep themselves informed about occurrences, to verify the existing compliance system and to establish a corresponding efficient structure. Moreover, according to the Regional Court of Munich, the board may not delegate the implementation of the compliance system in detail to a lower level ("division managers"). The board must check out for itself whether and how

²²¹Regional Court of Munich, decision of December 10th, 2013, file no. 5 HK O 1387/10, "Siemens" – case / decision published end of March 2014.

the compliance system is implemented and whether it is appropriate and functional. In this respect the Regional Court of Munich states that the delegation of this central task of the corporation's statutory organ "board" to employees on a lower level constitutes a breach of duty. In the context of its monitoring duty it is the responsibility of each board member to ensure that a functioning compliance system is resolved by the board. Furthermore, a board member may not absolve her/ himself from his/ her responsibility by using the excuse that the remaining board did not follow her/ his ideas for the implementation of a compliance system in accordance to the applicable legislation. Indeed, an outvoted board member must participate in good faith in implementing the board's resolutions²²². This does however not apply if the resolutions do not comply with legal requirements. If the board members' proposals for improvement of the compliance system have not been taken into account by his board colleagues, the board member has to submit an appropriate counter response to its colleagues and, if necessary, to inform the supervisory board.

21. Having regard to the duty of compliance within a group, the question should be asked whether the discretion of the parent or dominating company is limitless or not. Reference here is not made to the set-up of the compliance organization (e.g. centralized compliance vs distributed compliance), but to specific actions undertaken by the compliance function. In particular, it should

²²²Fleischer, H. (2014). Aktienrechtliche Compliance-Pflichten im Praxistest: Das Siemens/Neubürger-Urteil des LG München I. *Neue Zeitschrift für Gesellschaftsrecht*, 17, 321-329.

be examined to what extent the discretion goes as far as general duties to prevent damage are involved, and insofar as specific obligations exist at group level, such as data protection laws.

22. As far as general damage pre-emption duties are involved, it has already been pointed out that most group legislations recognize that a group structure often entails a dominant role by a parent company vis-à-vis the other group entities²²³. One must thus distinguish between the duties of the dominant/parent company vis-à-vis the parent company itself on one hand, and the duties of the dominant/parent company vis-à-vis the subsidiaries/dominated companies²²⁴.

23. When considering the duties of the dominant/parent company vis-à-vis the parent company itself, the board of the parent company must in any case behave in accordance with the law. This extends to all its activities, and hence also to the the direction of the group. Moreover, the board of the parent company has to ensure an adequate group-wide organization²²⁵, and it makes no difference whether the group is organized centrally or decentrally: what

²²³Hofstetter, K. (1990). Parent Responsibility for Subsidiary Corporations: Evaluating European Trends. *International and Comparative Law Quarterly*, 39(03), 576-598.

²²⁴Nygh, P. (2002). The Liability of Multi-national Corporations for the Torts of Their Subsidiaries. *European Business Organization Law Review*, 3(01), 51-81.

²²⁵Schneider, T. (2009). *Möglichkeiten und Grenzen der Umsetzung der gesellschaftsrechtlichen und bankenaufsichtsrechtlichen Anforderungen an Risikomanagement auf Gruppenebene*. Berlin: Duncker & Humblot.

matters is that the parent company avoids damage (also reputational) at the level of its affiliated companies²²⁶.

24. As for the compliance duties of the parent company vis-à-vis its subsidiaries, arguably the parent company's board can exert some discretion. In fact, based on the group's organization, it can choose how to set up its control organization. More specifically, if the group has a centralized model, then the parent company board will accordingly intrude deep into its affiliated companies' activity²²⁷. It will do so by requesting information on a regular basis, monitoring and controlling their tasks and duties, and, when necessary sanctioning mis-compliance by the affiliated companies. On the contrary, if the group is decentralized and the parent company's role is only limited to, say, human resources and group financing, then the degree of "intrusion" by the parent company will be very limited, and reliance will be made on the boards of the affiliated companies. In this case, according to Schneider, the parent company will only have to make sure that the affiliated companies establish a compliance department²²⁸, but the affiliated companies still retain discretionary power as to how structure the department. Yet, one should also bear in mind that while parent companies often exert influence over subsidiaries by merely determining their strategy and finances (in the form of, e.g., targets for results,

²²⁶Miller, S. K. (1998). Piercing the corporate veil among affiliated companies in the European community and in the US. *American Business Law Journal*, 36(1), 73-149.

²²⁷Zoppini, A. (2002). I diritti della personalità delle persone giuridiche (e dei gruppi organizzati). *Rivista di diritto civile*, 48(6), 851-894.

²²⁸Schneider, U.H. (December 8, 2009). Compliance im Konzern. *NZG - Neue Zeitschrift für Gesellschaftsrecht*, 34, 1326.

turnover, investments etc.), it is not always clear whether such intervention alone triggers a duty on the part of the parent to supervise the subsidiary's compliance. Strategic and financial targets do not directly relate to the operational business. However, the risk that the competitive behaviour of the subsidiary may be decisively influenced by them, should not be dismissed out of hand. For example, executive bodies or employees of subsidiaries could be tempted to commit infringements if they were put under pressure to meet ambitious strategic or financial targets set by the group. The parent company must therefore make it crystal clear that such targets are only to be achieved within the limits of the law and it must furthermore monitor compliance with these principles as part of its strategic and financial control. This requires that the parent company implement or mandate adequate compliance systems at the subsidiary. In fact, if the exertion of influence is restricted to laying down strategic plans and financial targets, the connection to an infringement of competition law is not strong enough to presume that the parent acted negligently.

25. In its 2005 paper "Compliance and the compliance function in banks", dedicated to compliance and banks, also the Bank of International Settlements allows for a certain degree of discretion, while underlining that compliance principles apply both to individual banks and to the banking group as a whole: *"regardless of how the compliance function is organised within a bank, it should be independent and sufficiently resourced, its responsibilities should be clearly specified, and its activities should be subject to periodic and independent review by the internal audit function. [...] The principles should be applicable to all banks, although it is for*

individual banks to determine how best they should be implemented. A bank may be able to follow practices other than those set out in this paper which are also sound and which, taken together, demonstrate that its compliance function is effective. The way in which the principles are implemented will depend on factors such as the bank's size, the nature, complexity and geographical extent of its business, and the legal and regulatory framework within which it operates". Multinational banking groups have to respect the rules of conduct in force in all countries in which they carry out their activities. However, in Europe, following the Second EU Banking Directive (Directive 89/646/CEE), they answer in precedence to the supervisory regulations of the country of origin (home country control principle). In these cases, banks must identify the most appropriate organizational solutions to ensure the correct risk management which results from the need to respect all the provisions applicable in relation to the various areas of operation. Similarly, it is also appropriate that companies controlled by European banks operating abroad take care to conform to the holding company, even in cases where the rules of the countries in which the subsidiary is established do not have similar levels of awareness. The model of compliance must therefore be structured to allow the systematic exchange of directives and information, both top-down and bottom-up.

Chapter 5: Compliance and financial services (elements)

26. We have pointed out earlier in this research that MiFID provides a substantive regulatory framework for establishing a compliance function in entities active in investments services. MiFID requires investment services

providers to establish, implement and maintain adequate policies and procedures designed to detect any risk of failure by the investment services provider to comply with its obligations under MiFID. As part of this, the compliance function shall identify the level of compliance risk the investment services provider faces, taking into account the investment services and ancillary services provided by the investment services provider, as well as the types of financial instruments traded and distributed. The compliance risk assessment shall take into account the applicable obligations under MiFID, national implementing regulation and the policies, procedures, systems and controls implemented within the investment services provider in the area of investment services. The assessment shall also take into account the results of any monitoring activities and of any relevant internal or external audit findings. The compliance function's objectives and work programme shall be developed and set up on the basis of this compliance risk assessment. The identified risks shall be reviewed on a regular basis as well as adhoc when necessary to ensure that any emerging risks are taken into consideration (for example, resulting from new business fields or other changes in the investment services provider's structure). In particular, the monitoring programme foreseen under MiFID aims to evaluate whether the investment services provider's business is conducted in compliance with its obligations under MiFID and whether its internal guidelines, organisation and control measures remain effective and appropriate. Where an investment services provider is part of a group, responsibility for the compliance function rests with each investment services provider in that group. An investment services provider shall therefore ensure that its compliance function remains responsible for monitoring its own

compliance risk. This includes where an investment services provider outsources compliance tasks to another investment services provider within the group. The compliance function within each investment services provider shall, however, take into account the group of which it is a part - for example, by working closely with audit, legal, regulatory and compliance staff in other parts of the group. The risk-based approach to compliance shall form the basis for determining the appropriate tools and methodologies used by the compliance function, as well as the extent of the monitoring programme and the frequency of monitoring activities performed by the compliance function (which may be recurring, adhoc and/or continuous). The compliance function shall also ensure that its monitoring activities are not only desk-based, but that it also verifies how policies and procedures are implemented in practice, for example through on-site inspections at the operative business units. The compliance function shall also consider the scope of reviews to be performed.

Chapter 6: Cross-border groups and compliance duties

27. In practice, the necessity to establish compliance systems in multinational groups is becoming more and more apparent. The difficulties described above are increased as different legal systems apply, with jurisdictions crossing over to apply in others²²⁹. From a general perspective, it is perhaps advisable to compare the case in which the parent company is based in

²²⁹ Schneider, U.H. (2007). Corporate Manslaughter und Corporate Compliance. *EuZW - Europäische Zeitschrift für Wirtschaftsrecht*, 18/2007, 553.

the *home* state with the case in which affiliated companies are based in such jurisdiction (i.e. the state is merely a *host* state). In the former case, the dominant view is that organizational duties apply to the parent company, and, given the functional link to its affiliated companies, to the whole group. The question then can be raised, to what extent this duty can stretch into foreign jurisdictions. For instance, can the board of an Italian parent company be held liable for not establishing a compliance structure to avoid crimes by foreign affiliated companies? In the latter case, what duties are imposed on the Italian affiliated companies of a corporate group headquartered abroad? This question can be further elaborated by examining the case in which a foreign parent has no subsidiary nor branch in a given jurisdiction, but in any case conducts business in it.

28. The case in which the parent company is based in the home country shall be considered first. According to German doctrine, if the group management is based in Germany, it makes no difference whether risks and damage for the parent company result from the misconduct of a foreign or a domestic affiliate company²³⁰, insofar as the breach of statutory regulations abroad by the affiliate is concurrently resulting in a damage for the parent company. If the parent company establishes a multinational compliance department across the group, the limits under the law applicable to company groups depend on the respective statute of the affiliate company. In Italy, the question of how

²³⁰ Casper, M. (2012). Corporate Governance and Corporate Compliance. In du Plessis, J.J., Großfeld, B., Luttermann, C., Saenger, I., Sandrock, O., & Casper, M. (Eds.), *German Corporate Governance. International and European Context*. Berlin-Heidelberg: Springer, 389.

organizational duties shall be implemented group-wide is left unaddressed in civil law. Hence, guidance can be sought in Legislative Decree no. 231/2001, the Italian discipline on corporate criminal liability that also lays down specific exemptions for entities which choose to establish compliance departments and programs, and run them effectively. In Italian doctrine, the extent to which the corporate liability regime foreseen under Legislative Decree no. 231/2001 can be applied to crimes committed abroad is largely debated²³¹. Pursuant to art. 4 of Legislative Decree no. 231/2001 the entities having their main seat in Italy are held liable also for crimes committed abroad, unless these crimes are already pursued in the countries where they have been committed. In other words, it is not sufficient that a senior group manager is involved in a crime abroad to trigger the corporate liability regime foreseen under Legislative Decree no. 231/2001, but other specific conditions must apply as well²³².

29. The case in which a controlled company is domiciled in a country but its parent company is based abroad shall be considered now. This case is debated quite widely by scholarly authors, as it often entails a situation in which the affiliated companies are already embedded in a cross-border compliance system, and would therefore be subject to a double duty of compliance: one deriving from the local laws, and one deriving from group-wide compliance

²³¹Razzano, F. C., & Nelson, T. P. (2008). The Expanding Criminalization of Transnational Bribery: Global Prosecution Necessitates Global Compliance. *The International Lawyer*, 1259-1286.

²³²Fusco, E. (2007). Applicabilità del d. lgs. 231/2001 alle banche estere. *Responsabilità amministrativa delle società e degli enti*, (4), 179.

guidelines²³³. A position expressed by Italian prosecutors and judges to make the case that host state organizational duties apply is that insofar as foreign entities operate in Italy, even temporarily, they shall comply with Italian laws, regardless of the fact that the host State has similar/identical laws governing the same matter. In the Siemens case²³⁴, for instance, the analogy with the road traffic laws was made, suggesting that even if Germany had no prescription to use safety belts in Germany, this would not exempt German drivers to use them when in Italy. Also the re-examination of the Siemens decision (Giud. Mannocci) concluded: *“Whoever operates in Italy – individual or corporate entity – has to respect Italian law. Here an administrative offense is imputed to a foreign corporation connected to a crime made in Italy. The jurisdiction is Italian, even if the corporation adopted a compliance program in a foreign context. If a corporation does not adopt a compliance program, it is not per se illegal. Its relevance is on the corporation’s culpability.”* With this argument, Siemens was subjected to a specific sanctions regime foreseen under Art. 9, par. 2, lett. c) of Legislative Decree no. 231/2001 even if the German section 30 of the OWiG did not entail the obligation to adopt specific organization models²³⁵.

²³³Baritti, S. (2006). L'applicazione del d. lgs. n. 231 del 2001 a società estere operanti in Italia: il caso degli istituti di credito e degli intermediari finanziari (Tribunale di Milano, ord. 27 aprile 2004--Tribunale di Milano, ord. 28 ottobre 2004). *Diritto del Commercio Internazionale*, 20(3), 805.

²³⁴Trib. Milano, sez. XI Giud. Riesame, Pres. Rel. Mannocci, ord. 10-28-2004, Siemens, AG.

²³⁵Martín, A. N., & de Morales, M. M. (2014). Compliance Programs and Criminal Law Responses: A Comparative Analysis. *Preventing Corporate Corruption*. Berlin: Springer International Publishing, 333-362.

30. Triangular situations can also easily take place. For instance, a parent company based in country A, and its subsidiary based in country B could find themselves jointly bidding for a tender in a third country. Alternatively, two companies of the same group but based in different countries may participate in a project that is wholly or partly funded with EU funds.

31. In 2015, the likelihood that a group subsidiary operates in a host country without its group having a compliance program whatsoever is fairly low. In fact, as has been discussed earlier in this research, pressure is mounting also from the private business world through “P2P (private-to-private) compliance” to embed compliance in everyday business activities. A pressing legal question, on the contrary, is what the legal value of a compliance program will be outside its home jurisdiction. So far, little elements can be found in Italian caselaw to assess this: it is still unclear how a foreign compliance model would be regarded in Italy under Legislative Decree no. 231/2001. More specifically, while it is clear that Italian laws - i.e. corporate criminal liability - would be applied regardless whether the parent in the home country has adopted a group-wide compliance department, it is unclear whether a foreign model would be seen as equivalent to the model foreseen under artt. 6 and 7 of Legislative Decree no. 231/2001. On one hand, it is argued that the model foreseen under artt. 6 and 7 of Legislative Decree no. 231/2001 is the only one admitted in order to benefit from the corporate liability regime exemption. On the other hand, it is noted that even more important than the existence of the model foreseen under artt. 6 and 7 of Legislative Decree no. 231/2001 is the effective implementation of measures designed to avoid crimes. Therefore, a

case-by-case analysis seems to be the most appropriate solution in order to assess the specific situation of subsidiaries with a foreign parent company. Another extremely interesting aspect is whether in the future it will be possible to have some sort of “organizational equivalence” in the compliance field. While assessing equivalence of organizations across different jurisdictions has long been a Sisyphean task, standardization of processes could help overcome many difficulties in this field. For instance, if a compliance organization were to be designed according to the newly developed ISO 19600 standard, this would certainly contribute to greater comparability of compliance organizations. This idea is clearly a driving element of the ISO 19600 standard, and its introduction states the following: *“in a number of jurisdictions, the courts have considered an organization’s commitment to compliance through its compliance management system when determining the appropriate penalty to be imposed for contraventions of relevant laws. Therefore, regulatory and judicial bodies can also benefit from this International Standard as a benchmark”*. The flexible approach of ISO 19600 is noteworthy. In fact, every organization can decide independently to what extent the implementation is still deemed proportional (with regard to the involved costs and benefits). The structure combined with the overlying principle of continual improvement enables organizations to act in accordance with ISO 19600 in every stage of their compliance management system development and to improve upon it. Moreover, a global standard will add comparability between compliance systems in different jurisdictions and industries. The guideline can be used globally due to its broad scope and its character as a recommendation-only standard. In addition, the guideline brings with it no risk of a conflict with any national law. However, it should also be noted out that it is still unclear

how organizations are supposed to prove their implementation of the ISO recommendations to others. Currently, there is no certification according to ISO 19600, and ISO standards can overlap with existing domestic standards²³⁶. Therefore, it can occur that a compliance officer is confronted with conflicting provisions, especially since the definitions are inconsistent. This is not harmful *per se*, since ISO 19600 is compatible with other compliance measures, but it still counteracts the aspired global standardization. It is discussed whether a true global standard is needed. Since there is no majority to be found amongst the ISO members for establishing a certification according to ISO 19600, at least the national standardization institutes should coordinate and adapt their respective national standards structurally and conceptually to ISO 19600. However, the ISO's approach could change. In case the ISO members find a majority a certification (or at least an affirmation to comply with the guideline) according to ISO 19600 might be possible in future.

32. So far, only cases with a corporate presence have been considered (parent or subsidiaries). While corporate presence represent a significant portion of cross-border compliance analysis, there also cases in which there are compliance issues despite the absence of a corporate presence in a given country. As a 2005 Financial Times article reported, "*You can be doing business outside the US and find you have got a problem with US sanctions for example, which*

²³⁶Paulitsch, H. (2014). *Austria: ISO 19600: Compliance Management Systems – Guidelines*, available online at:<http://www.schoenherr.eu/knowledge/knowledge-detail/austria-iso-19600-compliance-management-systems-guidelines>.

in certain circumstances is just not obvious"²³⁷. In many jurisdictions public prosecutors as well as private parties are proving capable of using local legislations to pursue players whose links with the country of the suing party are not immediately evident. An example of this state of facts is the recurring use, in the United States, of the Alien Tort Claims Act, a U.S. statute relating to "piracy on the high seas" and dating back to 1789, that today is used to pursue multinational companies through the U.S. courts for human rights abuses committed abroad by foreign governments with which they have been operating jointly. Moreover, as international commerce expands and the speed of cross-border transactions increases, companies doing business overseas face a daunting challenge – compliance with the anti-bribery provisions of the U.S. Foreign Corrupt Practices Act (FCPA) and similar laws imposed by other countries²³⁸. The stakes are high, as evidenced by the trend of FCPA investigations and prosecutions by US and foreign regulators over the past five years: since 2003, the number of FCPA enforcement actions brought by the US Department of Justice and the Securities and Exchange Commission has increased from an average of two or three cases per year to 38 enforcement actions in 2007²³⁹. These cases have resulted in record fines and penalties as well as disgorgement of profits for violations of the Act. As worldwide initiative to stop bribery gain momentum, companies face not only FCPA enforcement

²³⁷Financial Times(April 14th, 2005).*New strategic role of legal risk.*

²³⁸Kaikati, J. G., et al., (2000). The price of international business morality: Twenty years under the Foreign Corrupt Practices Act. *Journal of Business Ethics* 26.3, 213-222.

²³⁹Salbu, S.R. (1997). Bribery in the global market: A critical analysis of the Foreign Corrupt Practices Act. *Wash. & Lee L. Rev. - Washington and Lee Law Review*,54, 229.

actions in the United States but also the possibility of independent or concurrent enforcement actions in other jurisdictions²⁴⁰.

33. Moreover, as discussed earlier in this research, back in 2004 an Italian court held a German company not resident in Italy and operating in Italy only through a temporary company grouping (s.c. "associazione temporanea d'impresa") accountable for criminal offences (namely: bribery) committed in Italy²⁴¹. More specifically, the Italian Supreme Criminal Court stated that Italian criminal laws are applicable to a criminal offence committed abroad if there is *any* connection with Italy, even if the connection is not per se a criminal breach, the rationale being that the connection "*has to be regarded as a fragment of larger criminal sequence that should not be taken singularly*"²⁴². Moreover, section 4 of Law no. 231/2001 foresees the application of Italian criminal laws - and sanctions - to entities which have their main seat in Italy and commit violations abroad.

²⁴⁰Earle, B. (1995). United States' Foreign Corrupt Practices Act and the OECD Anti-Bribery Recommendation: When Moral Suasion Won't Work, Try the Money Argument. *Dick. J. Int'l L. - Dickinson Journal of International Law*, 14, 207.

²⁴¹In the Siemens Case, the Court of Milan, in its verdict of October 28th, 2004, stated that it is almost self-evident that foreigners (both individuals and legal entities), when acting in Italy, shall comply with Italian legislation, regardless of the fact that similar rules exist in their country of origin.

²⁴² Italian Criminal Court, Sentence no. 4284/2000.

34. On a somewhat similar note, the UK Bribery Act 2010 came into force on 1 July 2011²⁴³. The Act – designed to counter the corruption of public officials – will also have extra-territorial application. Namely, the offences may be prosecuted if done by a British national or corporate or by a person who is ordinarily resident in the UK regardless of whether the act or omission which forms part of the offence took place outside the UK, and/or if any act or omission which forms part of the offence occurs within the UK. In addition, corporate criminal offences will apply to commercial organizations which have a business presence in the UK (regardless of where the bribe is paid or whether the procedures are controlled from the UK); this extends the reach of the legislation well beyond the current regime.

35. With a view to the previous paragraphs, it has been illustrated that cross-border groups face a considerable complexity, which, in turn, can result into burdensome compliance. Unsurprisingly, the combination of national laws and extraterritorial reach of many provisions suggest to implement group-wide compliance departments. This is also the view of the Basel Committee on Banking Supervision, whose position expressed in 2005 in respect of banking group compliance was the following one: “[...]Banks may conduct business

²⁴³Introduced to Parliament in the Queen's Speech in 2009 after several decades of reports and draft bills, the Act received the Royal Assent on April 8th, 2010 following cross-party support. Initially scheduled to enter into force in April 2010, this was changed to July 1st, 2011. The Act repeals all previous statutory and common law provisions in relation to bribery, instead replacing them with the crimes of bribery, being bribed, the bribery of foreign public officials, and the failure of a commercial organization to prevent bribery on its behalf. The Act's official full text version can be found on-line at: http://www.legislation.gov.uk/ukpga/2010/23/pdfs/ukpga_20100023_en.pdf.

internationally through local subsidiaries or branches, or in other jurisdictions where they do not have a physical presence. Legal or regulatory requirements may differ from jurisdiction to jurisdiction, and may also differ depending on the type of business conducted by the bank or the form of its presence in the jurisdiction. [...] Banks that choose to conduct business in a particular jurisdiction should comply with local laws and regulations. For example, banks operating in subsidiary form must satisfy the legal and regulatory requirements of the host jurisdiction. Certain jurisdictions may also have special requirements in the case of foreign bank branches. It is for local businesses to ensure that compliance responsibilities specific to each jurisdiction are carried out by individuals with the appropriate local knowledge and expertise, with oversight from the head of compliance in co-operation with the bank's other risk management functions. [...] The Committee recognises that a bank may choose to carry on business in various jurisdictions for a variety of legitimate reasons. Nevertheless, procedures should be in place to identify and assess the possible increased reputational risk to the bank if it offers products or carries out activities in certain jurisdictions that would not be permitted in its home jurisdiction".

Chapter 7: Whistle-blowing and corporate groups

36. Earlier in this research (Part I) we have pointed out that whistle-blowing schemes are a key element of many compliance schemes set up by companies and corporate groups, as compliance is essentially based on information flow. We have also pointed out that information flow itself faces some significant limitation posed by data protection laws, and that the limits are typically

strongest in cross- border groups²⁴⁴. On 14 November 2005, the Düsseldorf Regional Labour Court ("*Landesarbeitsgericht Düsseldorf*") ruled that Wal-Mart's whistle-blowing Policy breaches German labour law. The decision confirmed the Wuppertal Labour Court's ("*Arbeitsgericht Wuppertal*") previous decision of 15 June 2005 which held that the policy was unlawful. Interestingly, the courts left open the question of what requirements should be imposed in order for a whistle-blowing policy to comply with data protection law. The decision has drawn public attention to this very specific legal question. Companies, in particular US stock listed companies, are in a dilemma. On the one hand, US law obliges them to implement corporate governance listing standards for companies, including the implementation of procedures encouraging employees to report misconduct. On the other hand, European law (in particular data protection law) imposes mandatory restrictions on such whistle-blowing. Although expressly addressing only labour law issues, it held that an employer may request that his employees report misconduct. However, the precise scope of such a legal whistle-blowing obligation is still open. In the absence of relevant case law or administrative guidance, general data protection law provisions have to be applied. In the private sector, these provide for a balance of interests according to Section 28 Federal Data Protection Act ("*Bundesdatenschutzgesetz*"). The whole principle of balance of interests means it is not possible to make a general assessment of whistle-blowing policies; instead, policy provisions must be reviewed in each individual case. The

²⁴⁴ Schneider, U.H. (2010). *Sind die Einrichtung einer Whistleblowing -Stelle und der Schutz des Whistleblowers Teil guter Corporate Compliance?*. Festschrift für Peter Kreutz, Köln, S. 855.

balance of interests must consider, among other things, the severity of the alleged misconduct on the one hand; and on the other hand, the alleged infringer's interest in not becoming the subject of an unfounded investigation. In addition, the reporting employee's privacy interests must be taken into account.

37. A decision of the German Federal Court of Justice ("*Bundesgerichtshof*")²⁴⁵ indicates that German data protection law generally accepts whistle-blowing to a certain extent. Where can the line be drawn? According to Schneider, data protection and compliance are two duties which do not per se exclude each other²⁴⁶. Rather, on one hand compliance posits the respect, among other things, of data protection. On the other hand, the scope of compliance is restricted by data protection law and data protection criminal law. The interplay between compliance and data protection is not an easy one, as the collection, elaboration and use of personal data is only allowed insofar as specific, factual and thoroughly documented elements exist which underpin the suspect that a legal violation has occurred. With this in mind, pre-emptive data collection is in all likelihood not possible, nor are wide, unspecific investigations.

38. Germany is hardly the only country in which whistle-blowing schemes can entail a conflict with data protection regulations. France, for instance, is also a country with a consistent track record of verdict an official positions in which local regulators deemed whistle-blowing policies in breach of data protection

²⁴⁵BGH DB 1989, 1464.

²⁴⁶Schneider, U.H., & Schneider, S.H. (2007). Konzern-Compliance als Aufgabe der Konzernleitung. *ZIP - Zeitschrift für Wirtschaftsrecht*, 44, 2061-2065.

laws²⁴⁷. As a backgrounder, when whistle-blowing schemes rely on the processing of personal data, i.e. on the collection, the registration, the storage and the disclosure of data related to an identified or identifiable person, they are subject to the provisions of the French Data Act. When such systems are carried out in an automated form, they are subject to a requirement of prior authorization by the French data protection authority “Commission Nationale de l’Informatique et des Libertés” (CNIL) pursuant the French Data Protection Act, due to their qualification as processing operations that may exclude individuals from the benefit of a right or of their employment contract in the absence of any specific legal provision. In two decisions issued in May 2005, the CNIL refused to approve two ethical hotlines set up by US companies to comply with SOX requirements on corporate governance²⁴⁸. In order to comply with SOX requirements, two French subsidiaries of American companies, McDonald’s France and CEAC, sought permission to establish anonymous employee whistleblower hotlines and asked the CNIL to register the systems for use in France²⁴⁹. The system set up by MacDonal’d’s France which resulted from the code of Ethics of the international McDonald’s group, allowed the staff of the French subsidiary to report to the American parent company (McDonald’s Corporation) either by mail or by fax, on the behaviour of their

²⁴⁷Baumgartner, F. (2007). Whistleblower Procedures and Personal Data Protection in France. *Corporate Governance Law Review*, 3, 206.

²⁴⁸Dowling Jr, D. C. (2008). Sarbanes-Oxley Whistleblower Hotlines Across Europe: Directions Through the Maze. *Int'l Law. - International Lawyer*, 42, 1.

²⁴⁹Marchini, R. (2006). Conflict of Laws: Anonymous Whistleblowing Hotlines Under Sarbanes-Oxley and European Data Protection Laws. *Privacy & Data Security Law Journal*, 575.

colleagues “deemed contrary to the French legal rules as well of the Code of Ethics”. The system set up by CEAC (Compagnie européenne d’accumulateurs), established by the parent company, Exide Technologies, permitted all the employees of the group to “communicate with the Surveillance Accounting Committee of the Board of Directors of Exide on issues such as accounting inaccuracies or irregularities which could occur”. The hotline also permitted employees to report to the management of the group on possible violations of company principles (rules of ethical or commercial conduct) or of laws currently in force. According to the French CNIL, the schemes at stake were at risk of compressing the liberty of employees, and represented a disproportionate response. In fact, the CNIL first considered that the employees subject to a denunciation would not be immediately informed of the collection of data questioning their professional or personal integrity and would not be in a position to oppose such collection, which would infringe the French Data Protection Act. Second, the CNIL pointed out that these systems were disproportionate to the aim they seek to achieve regarding the risks of slanderous denunciations and the stigmatization of employees having been subjects of an ethics alert²⁵⁰. The CNIL noted in this respect that other legal means²⁵¹ existed in order to ensure compliance with legal provisions and company rules (e.g. trainings, audits and alerts by the statutory auditors for financial and accounting issues).

²⁵⁰Lanois, P. (2007). Sarbanes-Oxley, Whistleblowing, And European Union Data Protection Laws. *Practical lawyer Philadelphia*, 53(4), 59.

²⁵¹Katz, G., & Lenglet, M. (2010). Whistleblowing in French Corporations. *Philosophy of Management*, 9(1), 103-122.

Chapter 8: Why the group compliance officer's powers (and responsibilities) are not unrestrained.

39. With a view to the paragraphs above, it is increasingly clear that the job of group compliance officer is a Sisyphean task, as foreign laws and/or courtrooms could extend its responsibility to all of the group in spite of the existence of compliance officers at the level of group subsidiaries. Earlier in this research, we have recalled that the duty of compliance officer entails specific responsibilities. In order to understand these responsibilities, a famous German Federal Court sentence was mentioned. In the Court's words "*the duty of a Compliance Officer is to prevent infringements of the law, especially crimes, which are conducted out of the company. Such Officers regularly have a duty to act according to sec. 13 Penal Code.*" The approach of the court was not only a reference to the increased importance of compliance, but also raised interesting questions regarding the liability of a compliance officer. The task of many compliance officers is the prevention of crime, but the Court has not dealt with any of these problems. It is therefore not clear whether the court wants to constitute a new kind of responsibility for compliance officers and the management. Limitations, however, should arguably apply for the group compliance officer, and his duty should be examined relative to a number of elements. Firstly, in many jurisdictions and legal disciplines, the corporate group is no legal persona *an sich*, so reference shall be made only to individual companies, whose boards can be held liable for wrongdoings and crimes. The extension of compliance duty to the whole group – and hence to the parent company – is only possible if specific reasons are provided to demonstrate an active involvement of the parent

company. Secondly, one of the overarching guiding principles of compliance management is that it should be commensurate to the complexity of the business and to its architecture. Recently issued standards such as the ISO 19600 standard dedicated to compliance management system can prove useful, but in the absence of a certification system it is quite difficult for a company – not to speak of an entire group – to prove the implementation of the ISO recommendations to others, so comparability of compliance undertakings will remain hard to achieve. However, in many cases compliance officers are merely obligated to report to the chief executive officer. If they fulfill this obligation, there is no room for a liability based on omission²⁵². Thirdly, as recalled earlier, in the scholarly debate there are already comments which characterize the parent company's compliance officer advising group subsidiaries as an "external consultant" and believe that in such capacity he is bound by confidentiality and attorney privileges. Therefore conflicts can in particular arise when the group compliance officer is a lawyer and deals with group subsidiaries²⁵³. Fourth, the compliance officer may face limitations in his day-by-day job which are themselves the outcome of legal compliance. As pointed

²⁵² Engelhart, M. (2010). Die neuen Compliance-Anforderungen der BaFin (MaComp). *ZIP - Zeitschrift für Wirtschaftsrecht*, 1832 - 1838; Lösler, T. (2008). Zur Rolle und Stellung des Compliance-Beauftragten. *WM - WertpapierMitteilungen*, 1098 - 1102; Rönnau, T. & Schneider, F. (2010). Der Compliance-Beauftragte als strafrechtlicher Garant, *ZIP - Zeitschrift für Wirtschaftsrecht*, 60.

²⁵³ Spaulding, N. W. (2013). Compliance, Creative Deviance, and Resistance to Law: A Theory of the Attorney-Client Privilege. *J. Prof. Law - Journal of the professional lawyer*, 135; McNeece IV, J. B. (2012). Ethical Conflicts of the Hybrid General Counsel and Chief Compliance Officer. *Geo. J. Legal Ethics - Georgetown Journal of Legal Ethics*, 25, 677; Hackett, S. (2012). Corporate Counsel and the Evolution of Practical Ethical Navigation: An Overview of the Changing Dynamics of Professional Responsibility in in-House Practice. *Geo. J. Legal Ethics - Georgetown Journal of Legal Ethics*, 25, 317.

out in this research, the access to information and data can sometimes generate conflict with data protection laws which exist in several foreign jurisdictions, and neither a board nor a compliance officer have legal powers to either override or disregard these laws – in fact in many jurisdictions these are no assistant public prosecutors (*“Hilfsbeamte del Staatsanwaltschaft”*).

Part III

Compliance as new international policy pattern

“On many issues most states have lost control over some of the functions of authority and are either sharing them with other states or with other (non-state) authorities..”

*Susan Strange*²⁵⁴

* * *

Chapter 1: Compliance and Corporate Social Responsibility

0. At the onset of this research, we have clarified that compliance is different from corporate social responsibility, but both elements are generally seen as each other's complement. What seems undeniable, indeed, is that the ultimate goal of compliance – the creation of a compliance department, crafting of guidelines and their implementation, etc.. – is not limited to ensuring adherence to the law, but entails a broader set of elements, and compliance and corporate social responsibility often time converge towards a single goal. Bayer's compliance policy, for instance, mentions that *“Bayer is conscious of its responsibility to protect health and the environment and ensure people's safety”* or

²⁵⁴Strange, S. (2007). *The Retreat of the State*. Cambridge: Cambridge University Press.

that “All employees are expected to behave in a friendly, objective, fair and respectful manner toward colleagues and third parties. Discrimination or harassment of any kind will not be tolerated”²⁵⁵. Compliance is not just about adherence with the law but also about containing reputation damage. Rules and their overall acceptance stem from the global *Zeitgeist*, and the current *Zeitgeist* attaches great importance to corporate behavior. The context of today’s global landscape should thus be examined in order to have a better understanding of the systemic forces that drive the debate around compliance and make it a key issue of our time. Access to information and media enables the public across the globe to be more informed and to easily monitor corporate activities, with a better understanding of the differences between technical compliance (adherence to the *letter* of the law) and actual compliance (adherence to the *spirit* of the law)²⁵⁶.

1. Based on the elements described in Part I and Part II of this research, it is clear that on one hand compliance duties derive from – general or substantive – legal obligations, on the other hand that compliance is a tool to avoid damage. With respect to corporate social responsibility, it may not be immediately clear whether the purpose of corporate social responsibility initiatives is a similar one. In particular, conventional wisdom that starts out from the actor-centered assumption that the prime function of business actors is, and has to be, profit

²⁵⁵Available on-line at: <http://www.bayer.com/en/corporate-compliance-policy.aspx>

²⁵⁶Gabel, J.T.A, Mansfield, N.,& Houghton, S. (2006).Letter vs. spirit: The evolution of compliance into ethics. *American Business Law Journal*, 46.3, 453-486.

maximization is contradicted. In Milton Friedman's view²⁵⁷, no code of conduct would ultimately be capable of setting market demands by force. However, this assumption and the consequences derived from it are often an oversimplification, as it neglects the fact that the market place is not the only environment that makes demands on business. Rational business actors have to take into account the challenges posed by globalized markets and those emanating from the state and from transnational civil society.²⁵⁸ The interaction of the three worlds of market, state and civil society²⁵⁹ provide for a normatively enriched environment, to the extent that the very word "market" may acquire a different meaning under these altering context conditions.

2. In the face of public pressure or the threat of state regulation, "doing good"²⁶⁰ – and, accordingly, be proactively compliant with rules and norms – may be the most rational strategy for business to evade the risks associated with adverse campaigning or public regulation. In fact, one the ironies or the recent era of deregulation business (in terms of state control) has been the

²⁵⁷ Friedman, M. (1995). The social responsibility of business is to increase its profits. In Hoffman, W.M., & Frederick, R.E. (Eds.), *Business Ethics: Readings and Cases in Corporate Morality*. New York: McGraw Hill, 137-141.

²⁵⁸ McCormick R. (2009). *Legal risk in the Financial Markets following the Global Financial Crisis*. Available at <https://community.oecd.org/community/gcls/blog/2009/07/15/legal-risk-in-the-financial-markets-following-the-global-financial-crisis-a-uk-perspective>; Strange, S. (1988). *States and Markets*. London: Pinter Publisher.

²⁵⁹ Anheier, H., & Themudo, N. (2002). Organisational forms of global civil society: implications of going global. In Glasius, M., Kaldor, M., & Anheier, H.K. (Eds.), *Global Civil Society*. Oxford: Oxford University Press, 191-216.

²⁶⁰ Collins, J.C. (2001). *Good to Great*. New York: Harper Business.

simultaneous expansion of constraints imposed by civil society²⁶¹. Non-governmental activity on a global scale has now become a key part of the discourse of globalization²⁶² and is routinely identified as one of the key drivers of the contemporary emphasis on corporate accountability²⁶³. It comes as no coincidence, for instance, that the European Union constantly acknowledges the importance of social and market pressures²⁶⁴, noting that civil society must be recognized as playing a significant role in this new business governance²⁶⁵. In fact, UN Secretary General Kofi Annan's Global Compact is what economists call a social-norming proposition²⁶⁶. By signing on to it, corporations agree to

²⁶¹Cashore, B., Auld, G., & Newsom, D. (2004). *Governing Through Markets: Forest Certification and the Emergence of Non-State Authority*. New Haven, CT: Yale University Press; Cashore, B., Auld G., Bernstein, S., & McDermott, C. (2007). Can non-state governance "ratchet up" global environmental standards? Lessons from the forest sector. *RECIEL – Review of European Community and International Environmental Law*, 16 (2), 158–72; Clapp, J. (1998). The privatization of global environmental governance: ISO 14000 and the developing world. *Global Governance*, Vol. 4, No 3, 295–316.

²⁶² Aman, A. (1998). The Globalizing State: A Future-Oriented Perspective on the Public/Private Distinction, Federalism, and Democracy. *Vanderbilt Journal of Transnational Law*, 769–870.

²⁶³ Hester, J.M. (1975). Social responsibility of organisations in a free society. In Backman, J. (Ed.), *Social Responsibility and Accountability*. New York: New York University Press; Spitzer, E. (May 1st, 2002). The crisis of accountability. Full text at www.oag.state.ny.us/press/statements; Reich, R.B. (1998). The new meaning of corporate social responsibility. *California Management Review*, 40/2, 8–17.

²⁶⁴ Simmons, B. A. (2008). *The Global Diffusion of Markets and Democracy*. Cambridge: Cambridge University Press.

²⁶⁵ COM (2002) 347: *Communication from the Commission concerning Corporate Social Responsibility: A business contribution to sustainable Development*, available on-line at: http://europa.eu/legislation_summaries/employment_and_social_policy/employment_rights_and_work_organisation/n26034_en.htm.

²⁶⁶ Cetindamar, D., & Husoy, K. (2007). Corporate social responsibility practices and environmentally responsible behaviour: the case of the United Nations Global Compact. *Journal of Business Ethics*, 76, 163–76.

uphold certain broad values such as environmental standards²⁶⁷²⁶⁸ and human rights²⁶⁹, which of course include rights as workers, as consumers, as voters, as children, and as women. The very act of signing on to such a compact focuses the signatory corporations, as well as potential critics, on what they do and plan to do to achieve progress toward the objectives. These consist of widely shared and internationally affirmed social values broadly stated (such as removal of gender discrimination and child labor). Given the broad general nature of the compact's objectives, however, the specific steps they take are best left to the corporations, working with the democratic countries in which they operate.²⁷⁰ For instance, signatory companies operating in Germany can be expected to follow national legislation and act within their national rights. They would, for example, exercise their right to hire replacement workers freely, even though that helps cripple the right to strike. But they would be expected to reduce wage

²⁶⁷Christmann, P., & Taylor G. (2003). Environmental self-regulation in the global economy: the role of firm capabilities. In S. Lundan (Ed.), *Multinationals, Environment and Global Competition*. Amsterdam: Elsevier/JAI, 119-46.

²⁶⁸Cashore, B., Auld G., & Newsom D. (2004). *Governing Through Markets: Forest Certification and the Emergence of Non-State Authority*. New Haven: Yale University Press.

²⁶⁹Addo, M. K. (1999). *Human rights and Transnational Corporations – An Introduction. Human Rights Standards and the Responsibility of Transnational Corporations*. London - Boston: Kluwer Law International, 3-37.

²⁷⁰ Nongnooch, K., & Sherer, M. (2004). Corporate social accounting disclosure in Thailand. *Accounting, Auditing & Accountability Journal*, Vol. 17 Iss: 4, 629 – 660; Amba-Rao, S.C. (1993). Multinational corporate social responsibility, ethics, interactions and Third World governments. *Journal of Business Ethics*, 12, 553-572; Stuckelberger, C. (2002). *Global Trade Ethics. An Overview*. Geneva: WCC - World Council of Churches Publications.

discrimination against women because Germany accepts that objective explicitly and enforces it.²⁷¹

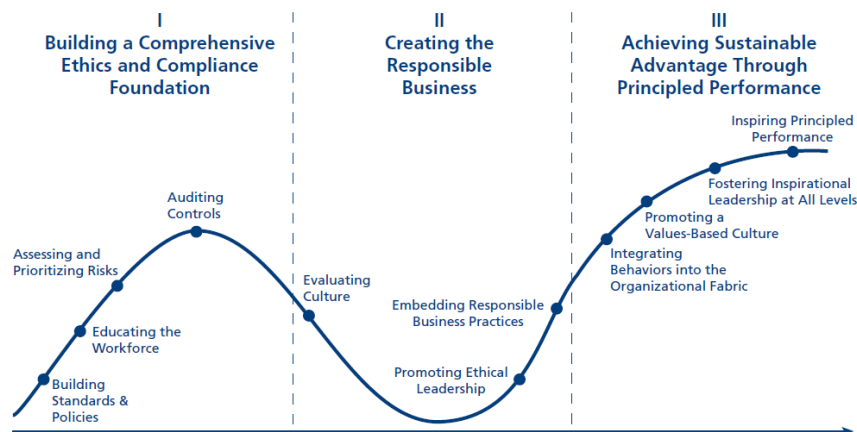
Chapter 2: Compliance as an evolutionary path from rules-based corporate behaviour to values-based behaviour

3. With a view to the above paragraphs, “doing good” and “behaving properly” clearly are part of a strategy to avoid reputational risks, and so is the production of private norms and the stiff increase of compliance that originates from this phenomenon.²⁷²In many presentations compliance is generally described as an evolutionary path from rules-based to values-based compliance²⁷³.

²⁷¹Chen, S., & Bouvain, P. (2009). Is Corporate Responsibility Converging? A Comparison of Corporate Responsibility Reporting in the USA, UK, Australia, and Germany. *Journal of Business Ethics* Volume 87, Supplement 1 (2009), 299-317.

²⁷² Richman, B.D. (2004). Firms, Courts, and Reputation Mechanisms: Towards a Positive Theory of Private Ordering. *Columbia Law Review*, 104,2328.

²⁷³ The graph above is freely adapted from the UK 2010 Bribery Act’s official presentation, available online at: <http://www.ukbriberyact2010.co.uk/images/stories/bribery-act8.png>.



In order to minimize reputational risk, private self-regulation must prove successful if it really wants to prevent legally binding regulation (state, “hard law” regulation) being imposed. However, this embedding in pending public regulation could have yet another impact on private efforts trying to anticipate and prevent state intervention: even if public regulation follows at a later stage, its substance would be pre-shaped by the norms and rules of private self-regulation. These expectations of the potential impact of the fear of forced compliance go along with the suspicion that in the absence of this threat the reliability of voluntary self-commitments would suffer.

4. Consumers and investors are demonstrating increased interest²⁷⁴ in supporting responsible business practices and are demanding more information

²⁷⁴Brown, G.R. (1971). Corporate Counsel's Responsibility in the Age of Consumerism. *Food Drug Cosm. LJ – Food Drug Cosmetic Law Journal*, 26, 154.

as to how companies address risks and opportunities²⁷⁵. In a 2006 McKinsey survey of business executives, only 8% of the interviewed people thought companies were motivated to champion social or environmental causes and work hardly on their disclosure policies out of genuine concern. One of the leaders in the adoption of explicit accountability policies, codes and reports was Shell, its “transformation” having become a classic business school case study, and it was very much responding major reputation crises resulting from both environmental and human rights issues, particularly in Western Africa. The company’s operation in a state run by a military dictatorship accused of major and frequent human right abuses, the impact of oil extraction on indigenous population, and the campaigns of human rights organizations pointing the finger not just at the Nigerian dictatorship but at Shell itself amounted to a public relations disaster. Non-governmental organizations (NGOs) played a major part in the publicity and pressure that prompted Shell’s “transformation”, not only Greenpeace on the environmental side, but Amnesty International, Pax Christi and others on the human rights front, and the advancement of corporate accountability has to be seen in the context of the growth of a highly active a highly active and activist society, which has put significant pressure on business via campaigns, publicity, boycotts and pressures both for more transparency and for more socially responsible policies and practices.

²⁷⁵Whitehouse, L. (2003). Corporate social responsibility as citizenship and compliance: initiatives on the domestic. *European and global level, Journal of Corporate Citizenship*, 11, 85-98.

5. Central to the public debate on corporate behavior is the perceived deficiency of national and international law remedies regarding corporate accountability, and in particular the ability of available regulation to successfully govern a corporation's conduct, or even the conduct of a corporation's partners (most typically suppliers) in jurisdictions outside the corporation's home state²⁷⁶²⁷⁷. As a general consideration, the traditional boundaries of moral²⁷⁸ and legal accountability have already been breached and companies are now exposed to environmental and social failings well beyond their direct operations and into the supply chain. In the *Unocal ATCA* case²⁷⁹, the Ninth Circuit held that the company could be challenged in court simply for knowingly assisting human rights violations in the supply chain regardless of

²⁷⁶ See, e.g., *Leeuwarder Courant* December 7th, 2007; *AD/Groene Hart*, December 5th, 2007. The case can be summarized as follows: in December 2007 a labour conflict in India turned into a diplomatic incident when a Indian court issued international arrest warrants against several Dutch fair trade activists. These activists, involved in the struggle for fair labor conditions and freedom of trade union activities, were accused of libeling an Indian clothing factory. The alleged libel consisted of the fact that the Dutch organizations had accused the Indian company (Fibres and Fabrics International, FFI) of not providing adequate labor conditions to its workers, suppressing the freedom of speech and not respecting the freedom of organization of its workers. The Indian company produced jeans for several Western clothing brands amongst which the Dutch G-Star. G-Star said it had found no evidence of the stated abuses with regard to the labor conditions but terminated its relationship with FFI anyhow, under pressure of the continuing bad publicity.

²⁷⁷McBarnet, D. (2003). When compliance is not the solution but the problem: from changes in law to changes in attitude. In Braithwaite, V. (Ed.), *Taxing Democracy*. Aldershot: Ashgate.

²⁷⁸Carroll, A.B. (1991). The pyramid of corporate social responsibility: toward the moral management of organizational stakeholders. *Business Horizons*, 34/4, 39-48. Carroll, A.B., (2001). The moral leader: essential for successful corporate citizenship. In Andriof, J., & McIntosh M. (Eds.), *Perspectives on Corporate Citizenship*. Sheffield: Greenleaf Publishing, 139-151.

²⁷⁹ Rosencranz, A., Louk D., Doe V. (2005). *Unocal: Holding Corporations Liable for Human Rights Abuses on their Watch*. 2005 *Chapman Law Review*, available on-line at: http://lrights.igc.org/press/Unocal/chapmanlawreview_spring05.htm#FN2.

whether they wanted or requested them. When Ford became embroiled in the Firestone tire crisis, their initial defense was that they were not responsible, yet alone liable, for the failings of the tires which were warranted by the tire manufacturer. The hostile public reaction and barrage of legal actions rapidly caused them to accept responsibility for tires specified by them as part of the vehicle they had made and sold. Indeed, it was Ford and not Firestone who initiated a second major tire recall. In this and in many other cases, the distinction between moral and legal liability is being constantly tested, but companies are now having to weigh both aspects in deciding how they should respond to crises where responsibility could traditionally have been deferred to other parties in the supply chain.

Chapter 3: Compliance as a tool to mitigate “civil society litigation risk”

6. A corporate social responsibility-oriented compliance is also a means to minimize the risk of litigation risk coming from civil society. In fact, civil society has also played a very direct role in bringing law into play, often in innovative and even surprising ways, to enforce corporate responsibility, and increasingly to make it a legal obligation. Instead of just seeking to influence state or international legislation – i.e. public law – they have turned to the tools offered by private law, essentially tort and contract. One of the most creative examples is the use, in the United States, of the Alien Tort Claims Act (“ATCA”), a U.S. statute relating to “piracy on the high seas” and dating back to 1789, rarely used for two centuries. It is, nonetheless, currently proving the bane of multinational

corporations who are being pursued, via ATCA, through the U.S. courts²⁸⁰. The goal is to have them pay out compensation – and be seen to take responsibility – for human rights abuses committed abroad by foreign governments with which they have been operating jointly.

7. The use of ATCA is an example of highly creative legal enforcement by non-governmental organization concerned with human right abuses. It should also be recalled that new legal developments are directly and indirectly fostering voluntary corporate social responsibility²⁸¹ and market pressures, while new legal tools are being evolved, and old ones creatively used, to make what businesses had previously perceived as voluntary, or beyond the law, in fact legally enforceable. This is not, on the whole, new state regulation, nor international law, but other facets of law – often private law – being used by private parties, non-governmental organizations, business itself, and indeed governments under a different hat. All of this certainly raises interesting angles on the real nature of compliance, and on law's capacity to escalate. It also shows how social and market forces increasingly interplay with law, with more complex forms of governance emerging. Legal doctrines and processes are being used by non-governmental organizations as part of their overall strategy,

²⁸⁰Shamir, R. (2004). Between self-regulation and the Alien Tort Claims Act: on the contested concept of corporate social responsibility. *Law & Society Review*, 38 (4), 635-663.

²⁸¹Becheur, A., & Bensebaa, F. (2004). Responsabilite sociale des entreprises: acceptabilite, credibilite et legitimité des pratiques, paper presented at the 13th AIMS Conference, Normandie – Vallee de Seine; Capelle-Blancard, G., & Giamporcaro-Saunier S. (2006). L'investissement socialement responsable, nouveaux acteurs, nouveaux enjeux. *Cahiers Français*, 331, 70-77; Capron, M., & Quairel-Lanoizelee, F. (2004). *Mythes et réalités de l'entreprise responsable*. Paris: Editions La Decouverte.

and market forces are being stimulated and facilitated by legal measures. Activist players²⁸², have for example used company law to gain legal status and a legal voice within companies, making themselves not just external pressures on companies but internal pressures. They have done this through the simple expedient of buying shares, making themselves shareholders and exercising shareholder rights to bring about resolutions to annual general meetings. Such actions have provided a new means for their conventional role of awareness-raising, with significant publicity raised through reporting of their actions at annual general meetings. More than publicity has resulted, with changes in corporate policy also being accomplished. In California in 2004, the Interfaith Center on Corporate Responsibility²⁸³, an umbrella organization filing for a group of shareholding non-governmental organizations, withdrew a resolution destined for Occidental's annual general meeting only when the company agreed to adopt a human rights policy. Non-governmental organizations have thus used the opportunities available in law to move from the role of advocates outside the corporation to the role of legal actors within it. The shareholder resolution brought by the Ecumenical Council for Corporate Responsibility to Shell's 2006 annual general meeting²⁸⁴ was introduced as being proposed because of concerns about the "loss of production, environmental costs and reputational risk faced by our company". Amnesty International USA has also

²⁸²Schurr, S. (January 11th, 2006). *Fruitless? Activist Shareholders Could Be Losing Their Ability to Shake Managements*. Financial Times.

²⁸³<http://www.iccr.org/issues/>.

²⁸⁴Ecumenical Council for Corporate Responsibility (ECCR) official website, May 2nd, 2006, *ECCR urges Shell shareholders to vote yes to responsible resolution*, full text available on-line at: http://www.eccr.org.uk/dcs/NewsRelease_Shell_02May06.pdf.

extended the tactic into a base for more conventional campaigning by asking ordinary Americans to voice their concerns and priorities to institutional investors holding shares in their names, asking them to support shareholder resolutions addressing human rights. For instance, two resolutions pressed in 2006 were first, in relation to Dow Chemicals, seeking more help for the remaining 100,000 and more victims of Bhopal²⁸⁵, and, second, in relation to Chevron, regarding health and environmental issues in the Ecuadorian Amazon which Amnesty alleged were caused by the operations of Chevron's subsidiary Texaco²⁸⁶. This "Share Power" campaign, and the general exercise of shareholder rights to promote corporate responsibility, confronts and exploits the narrow legal interpretation of corporate responsibility as primarily to further shareholders' interests by making shareholders advocates of corporate responsibility.

Chapter 4: Contractual control and compliance

8. Besides court litigation, contractual control is another mechanism frequently used by businesses themselves to transform legal commitments into legal obligations, and to impose these obligations on other businesses. In fact, there is a growing trend for major companies to include compliance commitments in the terms and conditions they set out for their contracts with their own suppliers. While the market power of large companies vis-à-vis

²⁸⁵<http://www.amnesty.org/en/appeals-for-action/call-chemical-company-address-legacy-bhopal>.

²⁸⁶<http://www.amnestyusa.org/our-work/countries/americas/ecuador>.

suppliers is clearly an important factor in any influence accomplished, it is becoming regarded in business as best practice to formalize this as a legal obligation. The adoption of this controlling role by big business over its suppliers may be less surprising and less altruistic than it seems. Some of the companies whose reputations have been hardest hit by the human rights movement have found themselves pilloried for the practices of external suppliers which were not their legal responsibility, but for whose actions they were nonetheless held accountable²⁸⁷. Nike's experience vis-à-vis the child labour practices of its south-east Asian suppliers epitomizes this²⁸⁸. It may be no wonder then that companies increasingly require their external suppliers, as well as their own companies, to adopt corporate social responsibility codes of conduct, and are using the legal mechanism of contract to do so. So the pressures of market and civil society have had the knock-on effect of business exercising legal control over business. It might also be noted that the production of contracts is itself facilitated by companies' ability simply to incorporate standards already set by non-governmental organizations such the International Labour Organization (ILO). Nor is it just businesses that are using contract as a means of promoting corporate responsibility. National, local, and indeed supranational governments are not only using conventional regulatory law to foster corporate responsibility, but are also using their market power

²⁸⁷ Heydenreich, C. (2003). Zulieferbeziehungen aus Sicht der OECD-Leitsätze - Anspruch und Erfahrungen aus Perspektive von NGOs. In Germanwatch (Ed.), *Wie weit reicht die Verantwortung von Unternehmen. Handels- und Zuliefererbeziehungen von multinationalen Unternehmen*, Leverkusen: Moosdruck, 22-6.

²⁸⁸ Liubicic, R. (1998). Corporate Codes of Conduct and Product Labelling: the Limits and Possibilities of Promoting International Labour Rights Through Private Initiatives. *Law and policy in international business, vol. I*, 112-42.

coupled with private law. They do so, for instance, by including corporate responsibility in their own procurement contracts²⁸⁹. The Italian government, for instance, has required specified “green” standards for the companies whose goods and services it purchases, covering energy efficiency, greenhouse gas emissions, the efficient use of natural resources and raw materials, transport, pollution controls and appropriate sourcing of environmentally sensitive goods such as timber²⁹⁰. Californian and Massachusetts state procurement policies²⁹¹ are well known for their policy-driven stance, while a number of European states and the European Union have also included “sustainable” procurement in its official positions. One could question the fact that compliance is undertaken and virtuous behavior is incentivized within corporate groups because of fear. However, even if companies proclaim normative self-commitments only for strategic reasons without actually being convinced of their appropriateness, the importance of the societal environment lies in securing rule-consistent behavior by helping the logic of rhetorical self-entrapment to unfold.

Chapter 5: Compliance and activist investors

7. Another crucial factor that sparked attention vis-à-vis corporate engagement and served as a huge incentive for both corporate social responsibility and

²⁸⁹Carter, C.R., & Jennings, M.M. (2004). The role of purchasing in corporate social responsibility: a structural equation analysis. *Journal of Business Logistics*, 25 (1), 145–86.

²⁹⁰<http://www.buy-smart.info/project-en/project-participants/consip-spa/consip-spa2>.

²⁹¹Swanson, M. et al., Developing priorities for greener state government purchasing: a California case study, *Journal of Cleaner Production*, 13.7 (2005), 669–677.

corporate compliance is the rise of pension funds and activist investors²⁹². The greater integration of world capital markets - in particular in the European Union following the introduction of the Euro - and the growth in equity capital throughout the 1990s have also been a significant factor in rekindling interest in corporate governance issues. Increasingly fast growing corporations in Europe have been raising capital from different sources by cross listing on multiple exchanges²⁹³. In the process they have had to contend more with USA and UK pension funds. This has inevitably contributed to the spread of an “equity culture” outside the USA and UK, and to a multiplication of legal undertakings and requirements²⁹⁴. The growth in defined contribution pension plans, indeed, has channeled an increasing fraction of household savings through mutual and pension funds and has created a constituency of investors that is large and powerful enough to be able to influence corporate governance, as the share of financial assets controlled by institutional investors has steadily grown over the 1990s in OECD countries. This also comes with disproportionately large institutional holdings in small countries with developed financial centers, like Switzerland, the Netherlands and Luxembourg. Institutional investors in the

²⁹²Clark, G. (2004). Pension Fund Corporate Engagement: The Fifth Stage of Capitalism, *Industrial Relations*, 59 (1),142-71;Clark, G. (2003). *European Pensions and Global Finance*.Oxford: Oxford University Press; Clark, R.C. (1986). *Corporate Law*.Boston: Little Brown; Brooks, S.M. (2005). Interdependent and Domestic Foundations of Policy Change: The Diffusion of Pension Privatization Around the World. *International Studies Quarterly*,49 (2), 273-94.

²⁹³ Kern, S. (2008). EU-US Financial Markets Integration - a work in progress, Deutsche Bank Research Paper Series, available on-line at: http://www.dbresearch.de/PROD/DBR_INTERNET_DE-PROD/PROD000000000225963.pdf.

²⁹⁴Statman, M. (2000). Socially responsible mutual funds. *Financial Analyst Journal*, May-June, 30-90.

USA alone command slightly more than 50% of the total assets under management and 59.7% of total equity investment in the OECD²⁹⁵. This has led to the emergence of a service industry that makes voting recommendations and exercises votes for clients. These investors are becoming more demanding and they are one of the forces behind the rapid transformation of several corporate governance systems and the rising expectations around corporate accountability. In the United Kingdom, FTSE (the Financial Times Stock Exchange Index) introduced in 2001 the FTSE4Good²⁹⁶ index using criteria based on corporate social responsibility²⁹⁷. Dow Jones in the US has its Sustainability Indexes²⁹⁸. There are “socially responsible”, ethical and “green” investment trusts. FTSE4Good’s approach is to raise the bar over time, “engaging” companies to meet higher standards at each review and dropping companies that fail to do so. In its first three years it notably dropped 87 companies, including household names such as Goldman Sachs and Avon, while the introduction of more demanding human rights criteria resulted in 53 companies developing new policies and practices to ensure continued inclusion. Significantly, companies included in these indices make much of it in

²⁹⁵ Davis, P., & Steil, B. (2001). *Institutional Investors*. Cambridge: MIT Press, 296.

²⁹⁶http://www.ftse.com/Indices/FTSE4Good_Index_Series/index.jsp.

²⁹⁷Robertson, D.C., & Nicholson, N. (1996). Expressions of corporate social responsibility in UK firms. *Journal of Business Ethics*, 15/10, 1095; Ruggie J. (2006, June 14th). *Remarks delivered at a forum on Corporate Social Responsibility Co-Sponsored by the Fair Labor Association and the German Network of Business Ethics*. Bamberg. Text available on-line at: <http://www.reports-and-materials.org/Ruggie-remarks-to-Fair-Labor-Association-and-German-Network-of-Business-Ethics-14-June-2006.pdf>.

²⁹⁸<http://www.sustainability-index.com/>.

their sustainability reports²⁹⁹. Moreover, large pension funds can wield significant influence. CalPERS³⁰⁰, the Californian Public Employees Retirement Scheme Fund, announced in February 2002 that it was pulling out of investment in businesses in Thailand, Indonesia, Malaysia and the Philippines because they did not meet CalPERS investment criteria³⁰¹. Four years later, in June 2006, the Norwegian government pension fund, one of the largest in the world, withdrew investment from Wal-Mart and Freeport McMoRan Copper and Gold out of concerns about human rights and environment. With such significant levels of business value at stake, it is not surprising that shareholders are increasingly informed and active on the issues. The growth in ethical funds³⁰² is one clear indication, with the power of this still-niche sector to secure board attention to social and environmental issues disproportionate to its size. Mainstream investors are coming under increasing pressure and are even facing legislated requirements, as in the case of UK pension trustees, to disclose their policy on the inclusion of environmental and social issues in their investment

²⁹⁹ Ballou, B., Heitger, D. L., & Landes, C. E. (2006). The future of corporate sustainability reporting. *Journal of Accountancy*, 202(6), 65-67 and 70-74.

³⁰⁰ Cameron, D., Jacob, R., & Wine, E. (2002, February 22nd). *Calpers' Asian retreat is a victory for ethics: But the giant Californian pension fund's pull-back from four emerging markets goes against the tide*. Financial Times.

³⁰¹ Cameron, D., Jacob, R., & Wine, E. (2002, February 22nd). *Calpers' Asian retreat is a victory for ethics: But the giant Californian pension fund's pull-back from four emerging markets goes against the tide*. Financial Times.

³⁰² Whitehouse, L. (1998). The current trend in consumerism and its impact on the rights of home owners. In Cowan, D. (Ed.), *Housing: Participation and Exclusion*. Aldershot: Ashgate; Whitehouse, L. (2003). Corporate Social Responsibility as Citizenship and Compliance: Initiatives on the Domestic, European and Global Level. *Journal of Corporate Citizenship*, 11, 85-98; Whitehouse, L. (2003). Corporate social responsibility, corporate citizenship and the global compact: a new approach to regulating corporate social power? *Global Social Policy*, 3, 299-318.

and voting decisions. Arguably, a new element is represented also by the increased activism^{303,304} among mainstream investors. Part of this increase reflects the heightened focus on corporate governance, post-Enron. The huge losses in shareholder value have prompted investment managers to scour their portfolios for hidden risk, and investors are now keenly aware of the importance of good governance in protecting and enhancing the value of their investments. Even more significantly, mainstream investors seem to be gradually challenging some of the moral liability of the companies in which they invest. Shareholder resolutions have proliferated, demanding strategic reviews and responses on issues from climate change³⁰⁵ to genetically modified organisms (GMOs) to human and labour rights performance. Many have been able to achieve once unthinkable levels of support from the main body of shareholders.

Chapter 6: Compliance and risk management

8. One of the key factors contributing to compliance's international relevance is the unprecedented *legislative* emphasis on *risk management* these days. In fact, the importance of compliance in today's corporate debate also

³⁰³ Barlow, M., & Clark, T. (2002). *Global Showdown: How the New Activists are Fighting Corporate Rule*. Toronto: Stoddart.

³⁰⁴ Bielefield, S., Higginson, S., Jackson, J., & Ricketts, A. (2004). Directors' duties to the company and minority shareholder environmental activism. *C&SLJ - Company and Securities Law Journal*, 23, 28.

³⁰⁵ Aguilar, L. A. (2010). *Statement at open meeting - interpretive release regarding disclosure of climate change matters*. Speech presented at U.S. Securities and Exchange Commission, Washington, DC. Text available on-line at: <http://www.sec.gov/rules/interp/2010/33-9106.pdf>

reflects an overall attitude towards risk. More specifically, it reflects the confidence that risk can be *managed*, in the sense that “adequate” organizational features can reduce the life-threatening impact of risks on the company. Risk management-related regulation comes in many shapes. For instance, laws may require firms to adopt specific risk management/measurement techniques; impose corporate governance arrangements to manage risks, such as by requiring companies to have a risk committee within the corporate board, the presence of independent directors therein, internal “status” requirements for chief risk officers, separation of risk management from operating management functions, board duties to supervise risks, etc.; validate firms’ risk management models as a condition to more favorable regulatory treatment; impose a generic requirement to adopt adequate risk management procedures; require top management to certify the effectiveness of risk management (internal control) policies and procedures and identify material weaknesses thereof, and impose disclosure obligations to explain risk management governance, policies, and procedures to investors and the public at large³⁰⁶. European company law was long silent on risk management: if at all, it mentioned the board’s responsibility for internal organization. Such is the case of rules dating back as far as from the 1930s. But even where no such explicit rules were in place, it has always been clear that the board of directors and/or management were responsible for the adequate organization of a company as much as they were responsible for

³⁰⁶Enriques, L., Zetsche, D. (2013). The Risky Business of Regulating Risk Management in Listed Companies. *European Company and Financial Law Review*, 10(3), 271-303.

running the business³⁰⁷. Today, both at the European level as well as at national levels the board of directors is asked to pay more attention to **risk management**. Trust needs to be restored with adequate controls to mitigate the accidents that happened. The 2004 Transparency Directive requires that issuers' annual and interim reports include "a description of the principal risks and uncertainties that [it] face[s]" and "The interim management report shall include at least an indication of important events that have occurred during the first six months of the financial year, and their impact on the condensed set of financial statements, together with a description of the principal risks and uncertainties for the remaining six months of the financial year"³⁰⁸. The requirement to disclose the principal risks and uncertainties obliges companies to install at least a risk and uncertainty identification system. In a proposal for the modernization of this directive ESMA is empowered to issue guidelines with respect to these disclosure requirements³⁰⁹. The identification of risks was already required in the prospectus to be published when the company is stock exchange listed.

³⁰⁷ The same can be said about the first generation of financial services directives up to the mid-1980s: risk management was not explicitly mentioned. See Article 3 (4) of the First Directive on Credit Institutions (requiring a description of the organizational structure); Arts 16, 17 (2) of the First Directive on Non-Life Insurance of 1973 and Arts. 19, 20 (1) and (2) of the First Directive on Life Insurance of 1979. In a similar vein, the UCITS I of 1985 contained no rules on risk management as an organizational requirement.

³⁰⁸ Article 4, § 2, subpart c and article 5, § 4 Directive 2004/109/EG of the European Parliament and the Council of December 15, 2004 on the harmonization of transparency requirements with regard to information about issuers whose securities are admitted to trading on a regulated market, *OJ L* No 390 of December 31st, 2004, p. 38.

³⁰⁹ Proposal for a Directive of the European Parliament and of the Council amending Directive 2004/109/EC on the harmonization of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market and Commission Directive 2007/14/EC, COM(2011) 683 final, October 25th, 2011, p. 16.

Prospectus Directive 2003/71/EC and Commission Regulation 809/2004, which oblige companies to include risk factors in the prospectus. The list of risk factors must comprise company-specific risks and/or risks related to the securities issued that are material for taking investment decisions. Directive 2010/73/EU further clarified what information is considered “key information” in assessing risks related to the company and the securities:

[...] essential and appropriately structured information which is to be provided to investors with a view to enabling them to understand the nature and the risks of the issuer, guarantor and the securities that are being offered to them or admitted to trading on a regulated market and, without prejudice to Article 5(2)(b), to decide which offers of securities to consider further. In light of the offer and securities concerned, the key information shall include the following elements:

- (i) a short description of the risks associated with and essential characteristics of the issuer and any guarantor, including the assets, liabilities and financial position;
- (ii) a short description of the risk associated with and essential characteristics of the investment in the relevant security, including any rights attaching to the securities; [...].

Listed companies must also provide for an annual corporate governance statement according to the Directive 2006/46/EC amending the Fourth and Seventh Company Law Directives. This statement must contain “a description of the main features of the company’s internal control and risk management

systems in relation to the financial reporting process". On the consolidated level, "a description of the main features of the group's internal control and risk management systems in relation to the process for preparing consolidated accounts" must be provided. The statement can be integrated in the management report or be published as a separate report. The auditor's opinion is required to cover the consistency of the main features of the company's internal control and risk management systems in relation to the financial reporting process. The auditor's obligations related to the internal control and risk management system is limited to the financial reporting process, like the American requirements in SOX. Many of the aforementioned malpractices were either directly or indirectly related to financial "tricks" for which an adequate internal control system, controlled by an external expert, could be seen as an appropriate answer. The external auditor has to control the availability in the corporate governance statement on the description of the main features of the system in relation to the financial reporting process and issue an audit opinion. The Directive did not provide any guidance as to the level of work required, nor did it oblige the auditor to start a forensic audit. Next to the disclosure requirements in the Transparency and Accounting Directives, the Directive 2006/43/EC on statutory audits stipulates that public-interest entities must establish an audit committee (or alternative body) to monitor the financial reporting process and to monitor the effectiveness of the company's internal control, internal audit where applicable, and risk management systems. This obligation goes beyond the disclosure requirements of the Transparency Directive and the amendments of the Accounting Directives and covers one of the components of an enterprise risk management system. The monitoring

requirement, i.e. monitoring the financial reporting process as well as the internal control system, significantly increases the responsibility of the audit committee. According to Article 41 of Directive 2006/43/EC the audit committee must not only monitor the effectiveness of the internal control system of financial reporting, but the effectiveness of all internal control, internal audit and risk management systems. It can be derived from this duty that the company must install such systems allowing the audit committee to monitor their effectiveness but the Directive does not provide any guidance as to which kind of system is appropriate. The audit committee will have to collect information about all the different components and procedures of the applied systems and assess the functioning of the systems for which criteria need to be developed. The criteria allows the committee to assess if the systems provide for reasonable assurance that the goals can be reached. In 2005 the European Commission issued a recommendation on independent directors and committees of the board which contains additional guidelines structuring the audit committees' work. In fact, the recommendation is broader than the scope of the Directive 2006/43/EC on statutory audits. The recommendation contains several principles related to the role of the audit committee. This committee should assist the board in its task to, e.g. :

- review at least annually the internal control and risk management systems, with a view to ensuring that the main risks (including those related to compliance with existing legislation and regulations) are properly identified, managed and disclosed;
- ensure the effectiveness of the internal audit function, in particular by making recommendations on the selection, appointment, reappointment

and removal of the head of the internal audit department and on the department's budget, and by monitoring the responsiveness of management to its findings and recommendations. If the company does not have an internal audit function, the need for one should be reviewed at least annually;

- review the effectiveness of the external audit process, and the responsiveness of management to the recommendations made in the external auditor's management letter.

Both Directive 2006/43/EC on statutory audits and the Recommendation focus on the monitoring role of the audit committee, but they assign different roles to the audit committee with regard to monitoring the internal control system and its effectiveness, respectively. According to Directive 2006/43/EC the committee has a duty to perform the overall monitoring of the financial reporting process, but only has to monitor the effectiveness of the global system, whilst the Recommendation stresses the committee's duty of monitoring the global internal control system, but only has to assess the effectiveness of the internal audit function and external audit process. The statutory auditor must also "report to the audit committee on key matters arising from the statutory audit, and in particular on material weaknesses in internal control in relation to the financial reporting process". The role of the auditor vis-à-vis the internal control process is limited. The European auditor must report the material weaknesses but has no monitoring duty regarding the effectiveness control of the audit committee. According to Directive 2006/43/EC monitoring the effectiveness of the system in relation to financial reporting remains the sole duty of the audit committee. In the US, management

must provide an assessment of the effectiveness of internal control for financial reporting. In the recitals of Directive 2006/43/EC, the collective responsibility of the board is stressed. Article 41, paragraph 2 of Directive 2006/43/EC also emphasizes the responsibility of the board members. It stresses the delicate borderline between the audit committee's responsibilities and the board of director's responsibility. According to Directive 2006/43/EC the audit committee's duties go beyond the mere advisory work to prepare the board meetings. The committee has four monitoring duties and one reviewing task. The audit committee should inform the board of directors about the work program allowing the board to monitor the work of the committee.

Chapter 7: Risk management in courtrooms

9. Many risk-management-related rules are different from outcome-oriented or command-and-control regulations (substantive rules), as they provide a certain flexibility to companies to devise their own solutions to challenges. Risk management and compliance are examined more and more in case-law across the EU. In the the Netherlands' *Laurus* case³¹⁰, the Enterprise Chamber concluded that the Board of Directors takes irresponsible risks if, notwithstanding negative signals, it supports the continuation of the business plan even when it endangers the survival of the company. Closely related to this case is the decision of the Court of Utrecht that found both the board and the supervisory board liable because they have opted for a strategy without any

³¹⁰*Laurus*, Ondernemingskamer Gerechtshof Amsterdam, October 16th, 2003, 174/2003, LJN:AM 1450, <http://zoeken.rechtspraak.nl>(accessed 5 February 2013).

assessment of the thereto related risks³¹¹. The Court of Appeal of Mons (Belgium) found the board of directors liable for the bankruptcy of the company because there was not an appropriate risk management system in accordance with the size and operational activities of the company³¹². These cases illustrate that the courts will have increasing difficulties to judge without hindsight bias. The new legal and regulatory risk management requirements aggravate this hindsight bias risk. There are already some signs of increased accountability of directors for having business risk *mitigating* systems instead of risk *management* systems. In a recent Belgian case one director was convicted for the corporate breaching of the environmental legislation³¹³. The company fell short of compliance with the environmental legislation related to water sanitation. The board of directors systematically underinvested in the exploitation of the plant and priority was given to economize instead of complying with new environmental laws. The individual board member should have protested against this underinvestment which implies that board members must ensure that a system that identifies and mitigates regulatory (environmental) risks is in place. Although it consists of a criminal case, Belgian board members must object against (at least certain kinds of) risky activities and make sure that risk management systems identify these significant risks. Generally, the new risk management system requirements are open standards which leave many options to manage the risks. Yet, this flexibility may be deceptive. In fact, risk-

³¹¹ *Ceteco*, Rechtbank Utrecht December 12th, 2007, 171413/ HA ZA 04-34, LJN: BB,9709 <http://zoeken.rechtspraak.nl> (accessed February 5th, 2013).

³¹² Court of Appeal Bergen March 3rd, 2008, RRD 2008, 295-296.

³¹³ Court of Appeal Gent, November 25th, 2011, TRV 2012, 711, 734, comment S. De Geyter.

management-related rules typically offer a set of incentives if two conditions are met: a compliance organization is established, and its programmes and guidelines are effectively implemented. While there can be wide discretion as to how structure the compliance organization, not much guidance is given as to how ensure effectiveness³¹⁴. Moreover, as noted by Enriques and Zetsche, this kind of risk management-related regulation facilitates misperceptions about what risk management can and cannot do. While risk management as a managerial tool is inherently imperfect, the very assimilation of risk management into regulation³¹⁵ may have negative effects in two directions. On the one hand, *ex ante*, market participants, especially outside the firm, may develop a sense of misplaced security over how much a firm's management is in control of the outside world. The view that managing risk means having risks under control is obviously wrong, but it may only be natural to share it if risk management is legally and politically sanctioned and if firms heavily invest in it as a consequence. On the other hand, *ex post*, risk management regulation may well generate an opposite misconception on the part of law enforcers dealing with situations in which harmful events have materialized. If the law requires or expects adequate risk management policies and procedures, then it is easy to be led into thinking that, had those procedures been in place and complied with, no harmful event would have materialized, and hence that

³¹⁴ Rordorf, R. (2002). I modelli organizzativi e gestionali idonei a prevenire i reati. *Le società*, 1302.

³¹⁵ Graziani, G. (2002). I modelli organizzativo-preventivi e l'esperienza dei "compliance programs". *Dir. prat. Soc - Diritto e pratica delle società*, 28.

management or the board are at fault because their risk management procedures were below the minimal acceptable standard³¹⁶.

Chapter 8: Compliance and enforced self-regulation

10. As we have pointed out earlier in this research, with the exceptions of substantive provisions for specific sectors, it is controversial whether there is such thing as a duty of compliance embedded in general obligations. At the same time, it is undeniable that many boardrooms decide to establish compliance department because of the kind of incentives provided by certain regulations. The incentives³¹⁷ devised by the US Department of Justice (DOJ) represent an example of this approach, and a blueprint for regulations such as the Italian D. Lgs. No. 231/2001. In fact, through its unparalleled power to indict corporate entities, the DOJ and US federal prosecutors have grasped the ability to define and assertively impose guidance on what constitutes effective "corporate compliance". This constitutes a delegation of responsibility whereby the government commands firms *ex ante* to implement "effective" compliance programs³¹⁸, but offers little guidance for determining effectiveness. Moreover, the DOJ's compliance regulation grants regulated entities little opportunity to

³¹⁶Enriques, L., & Zetsche, D. (2013). The Risky Business of Regulating Risk Management in Listed Companies. *European Company and Financial Law Review*, 10(3), 271-303.

³¹⁷ Hamdani, A., & Klement, A. (2008). Corporate Crime and Deterrence. *Stanford Law Review*, 61,271.

³¹⁸Goldsmith, M., & King, C. (1997). Policing Corporate Crime: The Dilemma of Internal Compliance Programs. *Vanderbilt Law Review*, 50.1.

engage in experimentation³¹⁹. Instead, internal corporate compliance programs are the instrumentalities of hard law: formal regimes designed to supply internal monitoring and punishment³²⁰, so that the firm can then assist the government in fulfilling its duties of external monitoring and punishment³²¹³²².

11. Through promulgation of the prosecutorial guidelines alone, the DOJ has certainly encouraged the expansion of corporate compliance departments, as well as the purchase of compliance services, much of it in the form of legal advice and training, sufficient to support a burgeoning industry³²³. More specifically, by negotiating and administering deferred prosecution agreements, US federal prosecutors have caused³²⁴ corporations to reorganize their compliance departments and redesign the ways in which they monitor and interact with employees, fire key personnel, including high-level officers not formally accused of criminal wrongdoing, hire hand-picked internal monitors, who report to and take orders from prosecutors, and attend meetings with

³¹⁹Walsh, C.J., & Pyrich, A. (1994). Corporate compliance programs as a defense to criminal liability: Can a corporation save its soul. *Rutgers Law Review*, 47, 605.

³²⁰Alschuler, A.W. (2009). Two ways to think about the punishment of corporations. *Am. Crim. L. Rev.- American Criminal Law Review*, 46, 1359.

³²¹Kowal, S. M. (1998). Corporate compliance programs: A shield against criminal liability. *Food & Drug LJ- Food & Drug Law Journal* 53, 517.

³²²Weissmann, A. (2007). New Approach to Corporate Criminal Liability. *Am. Crim. L. Rev.- American Criminal Law Review*, 44, 1319.

³²³ Baer, M.L. (2009). Governing Corporate Compliance. *B.C.L. Rev.- Boston College Law Review*, 50, 949. Available at: <http://lawdigitalcommons.bc.edu/bclr/vol50/iss4/2>.

³²⁴Laufer, W.S. (2001). Corporate prosecution, cooperation, and the trading of favors. *Iowa L. Rev. - Iowa Law Review*, 87, 643.

board members regarding the company's outstanding compliance issues³²⁵. As Deferred Prosecution Agreements ("DPA"s) – contractual agreements whereby the government agreed not to prosecute the defendant corporation in return for the corporation agreeing to assist the government's investigations and to take remedial measures to improve its internal controls³²⁶ - began to proliferate³²⁷, the centralized policy-making arm at the DOJ headquarters exerted control over divergent practices that had developed throughout the individual United States Attorney's offices. In 1999, the Holder Memorandum, the first internal DOJ guideline memorializing "best practices" in corporate criminal prosecutions, was circulated to the individual United States Attorney's offices. The Holder Memorandum was intended primarily for line prosecutors and their local supervisors, some of whom were known to deviate from DOJ priorities when it suited their purposes³²⁸. By the end of 2000, following the collapse of a "dot.com"-inspired speculative economy, public firms issued a wave of financial restatements that shook investor confidence and depressed the equity market. In response to significant investor losses and widely reported apprehension about the integrity of capital markets, Congress enacted the Sarbanes-Oxley Act, and the Bush administration promised to vigorously prosecute the individual officers and employees that had been responsible for promulgating

³²⁵Bucy, P. H. (2007). Trends in corporate criminal prosecutions. *Am. Crim. L. Rev. - American Criminal Law Review* 44, 1287.

³²⁶Spivack, P., & Raman, S. (2008). Regulating the New Regulators: Current Trends in Deferred Prosecution Agreements. *Am. Crim. L. Rev. - American Criminal Law Review* 45, 159.

³²⁷Illovsky, E. (2006). Corporate Deferred Prosecution Agreements. *Criminal Justice*, 21, 36.

³²⁸Baker Jr, J. S. (2003). Reforming Corporations through Threats of Federal Prosecution. *Cornell L. Rev. - Cornell Law Review*, 89, 310.

securities frauds. Knowing that the prosecution of such individuals would be nearly impossible without the help³²⁹ of the corporations in which they worked, the government set out to shore up its legal apparatus in order to guarantee its ability to prosecute individual wrongdoers. In 2001, Larry Thompson, then Deputy Attorney General, released a revised memorandum that, unlike the earlier Holder Memorandum, explicitly commanded all prosecutors to consider entity-wide criminal liability³³⁰ for corporations whose employees were targets of investigations for criminal violations³³¹. Following the DOJ's lead, the SEC adopted a similar approach to judging corporate compliance and cooperation in its Seaboard Memorandum, which announced the release of a parent corporation from liability for the conduct of its subsidiary.

Chapter 9: "P2P" compliance and global governance

12. Thus far, we have investigated the relation between compliance and laws produced by a single state - or by a variety of states. Several scholars suggest that the unprecedented importance of compliance should also be examined with a view to the proliferation of *private norms*, which are increasingly filling voids in the international space. In other words companies become norm-

³²⁹Izraeli, D., & Schwartz, M.S. (1998). What can we learn from the US federal sentencing guidelines for organizational ethics. *Journal of Business Ethics* 17.9-10, 1045-1055.

³³⁰Bittle, S. (2004). Constituting the corporate criminal: corporate criminal liability in post-*Westray* Canada. In Institute of Governance, Public Policy and Social Research (Ed.), *Governing the Corporation: Mapping the Loci of Power in Corporate Governance Design, An International Colloquium*, London: Queen's University.

³³¹Wray, C. A., & Hur, R.K. (2006). Corporate Criminal Prosecution in a Post-Enron World: The Thompson Memo in Theory and Practice. *Am. Crim. L. Rev. - American Criminal Law Review* 43, 1095.

entrepreneurs – i.e. produce their own norms, comply with them and persuade other players to do the same. According to Killingsworth, *“by recasting compliance and ethics from a vertical, state-imposed constraint on business to an integral, horizontal expectation of how business is done, P2P (private-to-private) compliance encourages the adoption of best practices both as a cultural norm and, critically, as a path to profit. Coming now from external business partners rather than just the internal ethics and compliance staff, this message has the potential to re-orient some attitudes and remove some ethical blinders. As more businesses are forced by their counterparties to examine their compliance processes and routinely accept business and legal consequences for them, we can expect increases in overall investment in compliance, in the scope and robustness of the average compliance program, and in ambient awareness of compliance issues outside the compliance, audit, and legal staffs. The viral nature of the process, in which each participant can exert pressure on a large number of direct and indirect upstream or downstream parties, while simultaneously fielding demands from other members of its value chain, suggests that the trend will continue and its influence will grow”*³³². Moreover, according to Killingsworth, *private-to-private agreements “commonly contain several distinct types of provisions: broad human rights, labor and corporate social responsibility standards; ethical rules governing relationship issues such as conflicts of interest and gifts and entertainment; requirements to obey specific laws of concern and laws generally; and procedural rules such as the right to audit the partner’s records or train its personnel. Process and structural rules may be imposed on the partner’s compliance activities,*

³³²Killingsworth, S. (2014). The Privatization of Compliance. RAND Center for Corporate Ethics and Governance Symposium White Paper Series. Symposium on "Transforming Compliance: Emerging Paradigms for Boards, Management, Compliance Officers, and Government".

such as requirements to establish management accountability, develop appropriate policies and procedures, maintain an anonymous reporting system and an anti-retaliation policy, train employees, conduct periodic audits, risk assessments and remediation, and of course, sometimes to cascade these program elements to downstream associates”³³³. The likelihood of a spread of private compliance in the international space is strongest, because in the international space there is no single supranational regulator and states operate through agreements and cooperation treaties³³⁴. The international space, where many corporations are active, is exactly where government ends and “governance” begins. In fact, “global governance” is often defined in terms of what it is not – neither a world government nor the disorderly chaos and anarchy associated with a Hobbesian “state of war of all against all”.

13. In one of the pioneering studies of global governance published in 1992, James Rosenau defined global governance in general terms as “an order that lacks a centralized authority with the capacity to enforce decisions on a global scale”³³⁵. This conception of global governance was that of a purposive order that exists for the management of interdependence in the absence of a global state. His definition is very broad and has relatively little to say about who or what makes decisions, or precisely how enforcement takes place. Governance is derived from the Latin word *gubernator*, which is described both as a person

³³³Killingsworth, S. , *idem*.

³³⁴Flohr, A., Rieth, L., Schwindenhammer, S., & Wolf, K. (2010). *The Role of Business in Global Governance*. London: Palgrave MacMillan, 41.

³³⁵Rosenau, J. N., & Czempiel, E.O. (1992). *Governance without government: order and change in world politics*. Cambridge: Cambridge University Press.

who steers, and as a “self-acting contrivance for regulating” to ensure an even and regular motion³³⁶. This is an important distinction, and we will return to these two different aspects of how governance is accomplished in the discussion below. The Oxford English Dictionary (OED)³³⁷ defines governance as: (1) the idea of controlling, directing or regulating influence, as well as being subject to the control of another (a relational aspect); (2) the office, function, or power of governing; (3) the manner in which something is governed or regulated; and (4) the general conduct of life or business, demeanour, and “discrete or virtuous behaviour”, which adds a normative component to governance. Drawing on the origin of the concept and the different aspects of governance identified above, it is possible to define global governance in general terms.

14. Global governance requires first, some form of patterned regularity or order at the global level³³⁸. Patterned regularity is a necessary, but not a sufficient, condition for global governance. Second, following Rosenau³³⁹, and with acknowledgement of Hedley Bull’s important contribution, global

³³⁶Rosenau, J. N. (2007). Governing the ungovernable: The challenge of a global disaggregation of authority. *Regulation & Governance*, 1.1, 88-97.

³³⁷ Oxford English Dictionary (1971). *Complete Text, Volume I (A-O)*. Oxford: Oxford University Press.

³³⁸Biersteker, T. (2011). *Global Governance, the Sustainability of International Institutions, and the Potential Role of University-based Research Institutes*. Geneva: The Graduate Institute. Text available on-line at: http://graduateinstitute.ch/files/live/sites/iheid/files/shared/Winter/2013/Academic/Biersteker_Glion_Volume_chapter.pdf.

³³⁹ Rosenau, J.N. (1992). Governance, order and change in world politics. In Rosenau, J. N., & Czempiel, E.-O. (Eds.), *Governance without Government: Order and Change in World Politics*. Cambridge: Cambridge University Press, 1-29.

governance must be purposive and/or oriented toward the achievement of some goal or goals³⁴⁰. In this sense, and integrating it with the first element, global governance is order, plus intentionality, at the global level. Third, governance connotes a system of rule, or rules. These rules can either be formal and embodied within formal institutions, or they can be informal and reside inter-subjectively among a population or a set of key institutional actors. Global governance entails decisions that shape and define expectations (“controlling, directing, or regulating influence”) at the global level. There can be different degrees of institutionalization associated with different forms of governance, and there is much debate about whether formal or informal institutions are necessary for governance. Fourth, the system of rule implied by global governance is authoritative, in the sense that there is a social relationship between the governed and some governing authority. Governance requires acceptance by a significant portion of some relevant population and therefore is “as dependent on inter-subjective meanings as on formally sanctioned constitutions and charters”. Governments can persist without widespread popular support, but governance requires performance of functions necessary for systemic persistence. Governance should not be equated with government, but with the functions of government. Fifth and finally, as indicated above, given that the word governance is derived from the Latin word *gubernare* (both “to steer” and “to regulate”), it connotes some agent who steers the process, and it also allows for self-regulation. In this sense, a market or set of market

³⁴⁰Bull, H. (1977). *The Anarchical Society: A Study of Order in World Politics*. New York: Columbia University Press.

mechanisms can be said to govern. Thus, global governance is an inter-subjectively recognized, purposive order at the global level, which defines, constrains, and shapes actor expectations in an issue domain. It is a system of authoritative rule or rules (with varying degrees of institutionalization) that functions and operates at the global level. In order for a system of authoritative rules to operate at a global level, it is not required that they be universally practiced or universally recognized as legitimate. It merely requires that they be widely shared and practiced on a global scale (on multiple continents) by relevant and important actors.

Chapter 10: Compliance and systemic risk

15. This research has shown how significantly policymakers contributed to the rise of compliance, and is concerned with the way in which law could (and sometimes does) seek to hold businesses *accountable* for taking their *responsibilities* – or the responsibilities of their employees – seriously by using various mechanisms to encourage or enforce businesses to put in place internal governance structures, management practices and corporate cultures aimed at achieving responsible outcomes. Arguably, the shift towards enforced self-regulation reflects the idea that the kind of risks which arose these years requires strong engagement by the corporate community. In fact, a risk for private players can morph into a systemic risk³⁴¹. The one industry where

³⁴¹ Beisheim, M., Rudloff, B., & Ulmer, K. (2012). Risiko-Governance: Umgang mit globalen und vernetzten Risiken. *Stiftung Wissenschaft und Politik, Arbeitspapier FG 8, 2012/1*; Boeckelmann, L., & Mildner, S. (2011). Unsicherheit, Ungewissheit, Risiko. *SWP-Stiftung*

private interest coincides with public interest – and where the need for good compliance is highest – is perhaps the financial industry³⁴². Typically, entrepreneurs, as individuals, have an appetite for risk and that appetite is reflected in every kind of business enterprise, large or small, regardless of its legal form. Investors in such enterprises are expected to accept the risk that is inherent in the arrangement, although there are a great many laws and regulations to protect investors against the unscrupulous and, up to a point, the negligent. However, the activities of banks and other financial services enterprises give rise to other special considerations because they may attract funds not only from individuals as risk-taking investors but also from individuals – and others – who have either no appetite for risk (such as an account-holder with a major retail bank) or a much more conservative attitude to risk. The inter-connection of financial institutions in the wholesale financial markets, where they enter into transactions with each other involving enormous sums of money on a daily basis, also means that if one institution gets into financial difficulty there is a serious risk that the problem may spread rapidly to other financial institutions and cause serious financial instability. All of these special considerations require a degree of regulation and supervision – and, accordingly, compliance-related structures – which would not normally be necessary for commercial enterprises in non-financial sectors. Arguably,

Wissenschaft und Politik, September 2011; Mildner, S. (2011). Der Umgang mit dem Unbekannten. *SWP-Stiftung Wissenschaft und Politik -Aktuell*, June 2011.

³⁴²McCormick, R. (2009, July 15th). *Legal risk in the Financial Markets following the Global Financial Crisis: a UK perspective*. Global Charter/Legal Standard. (available on-line at <https://community.oecd.org/community/gcls/blog/2009/07/15/legal-risk-in-the-financial-markets-following-the-global-financial-crisis-a-uk-perspective>).

compliance often has systemic relevance, too³⁴³. In fact, as the international law reform organization UNIDROIT observed in 2004, there are particular features of legal risk that can result into a systemic reaction:

“[...] legal risk may become systemic [...]. Consider, for example, the scenario in which an entire market suddenly changes its behavior because the participants become aware of a major legal problem inherent in a specific kind of transaction unsuspected until then. In order to avoid this risk, the market participants avoid entering into this type of transaction as long as the problem remains unsolved. Such a mass reaction, if not properly restrained, could seriously damage the market. [...]”³⁴⁴

In this respect, a “War Game” simulation carried out by the UK regulatory authorities in 2004 to simulate risks to the financial system is very intriguing. In fact, the trigger event in the exercise was an imaginary unfavorable decision of the European Court of Justice: a classic example of compliance risk.

³⁴³Morton G. (2004). *Legal risk and its impact on market efficiency*. Acts of the UNIDROIT Seminar on Harmonised Substantive Rules regarding Securities Held with an Intermediary, available at <http://www.unidroit.org/english/documents/2004/study78/s-78-012-e.pdf>.

³⁴⁴ See UNIDROIT’s Explanatory Notes to the Preliminary Draft Convention on Harmonised Substantive Rules Regarding Securities held with an Intermediary, December 2004 (available at <http://www.unidroit.org/english/documents/2004/study78/s-78-019-e.pdf>).

Interestingly, according to the Financial Times³⁴⁵ the simulation assumed that the ruling of the court “created a behind-the-scenes run on banks that were heavily exposed to the property sector”. When debating the trade-off between the private interest of companies or corporate groups and the public interest, so far only cases of converging *negative* interests have been considered, i.e. cases where both private players and the public have an interest in avoiding compliance risk, as this risk could have systemic relevance. There is no scarcity of these cases these days, with an ongoing global financial and economic crisis. However, one should not be misled by the perception that the public interest and the private interest coincide only in bad times. This research, for instance, acknowledges the shift of functions which were previously a prerogative of nation-States to private players. Notably, these functions include the production of norms, in a scenario that several scholars have labeled as “co-production of statehood” or “co-performance of governance”³⁴⁶. The powers of nation-States, even of powerful ones, are not sufficient to solve global problems. Among the numerous strategies adopted by national governments to increase their problem solving capability, the more direct involvement of private actors in the governance process is of particular interest. This step toward societal participation was not primarily motivated by democratic concerns but followed the rationale of increasing problem-solving effectiveness by utilizing the knowledge and other resources that only private actors could provide. Co-opting the former addressees of state regulation as partners in decision making

³⁴⁵Financial Times (May 30th, 2009). *Chilling plausibility of bank's "war game"*.

³⁴⁶ Schuppert, G. (2008). *Von Ko-Produktion von Staatlichkeit zur Co-Performance of Governance*. SFB-Governance Working Paper, Series 12. Berlin: Freie Universitaet.

could also increase the support and acceptance of political decisions. The expectation of a cooperative response by business actors to becoming partners in new governance arrangements relies on different factors, such as market incentive for corporations to engage in norm-production and norm-implementation, corporations' interest in avoiding reputational costs or legally binding public regulation, or the exchange of information in learning processes designed to improve corporate capacities to enact their supposedly intrinsically motivated willingness to "do good". Law is primarily a social construct: the extent to which it is interpreted and applied depends on the initial legislation and on the degree to which its provisions are *accepted* by key stakeholders. The role of legislators and gatekeepers is thus crucial in setting standard and rules and closely guard legal definitions. However, public institutions alone are not sufficient to grant adequate compliance³⁴⁷, and there is strong evidence that also many non-state³⁴⁸ and non-governmental entities are playing a crucial role in defining compliance's contours and borders³⁴⁹. Back in 2004, the (then)

³⁴⁷Grabosky, P. (1995). Using non-governmental resources to foster regulatory compliance. *Governance*, 8, 527.

³⁴⁸Cashore, B., Auld G., Bernstein S., & McDermott C. (2007). Can non-state governance "ratchet up" global environmental standards? Lessons from the forest sector. *RECIEL - Review of European Community and International Environmental Law*, 16 (2), 158-72; Cashore, B., Auld, G., & Newsom, D. (2004). *Governing Through Markets: Forest Certification and the Emergence of Non-State Authority*. New Haven, CT: Yale University Press.

³⁴⁹ Shonfield, A., & Royal Institute of International Affairs (1965). *Modern Capitalism: The Changing Balance of Public and Private Power*. London: Oxford University; McBarnet, D. (2003). When compliance is not the solution but the problem: from changes in law to changes in attitude. In Braithwaite, V. (Ed.). *Taxing Democracy*. Aldershot: Ashgate; Cashore, B., Auld, G., & Newsom, D. (2004). *Governing Through Markets: Forest Certification and the Emergence of Non-State Authority*. New Haven: Yale University Press; Cashore, B., Auld G., Bernstein, S., & McDermott, C. (2007). Can non-state governance "ratchet up" global

chairman of the Securities and Exchange Commission William Donaldson made this aspect – the norm-setting function by corporate players and not only by the state – very clear as he pointedly chose a meeting of the industry-funded US Conference Board to launch an attack on the dangers of continued sharp practice.

“This erosion of trust in business is a serious and worrying development, and there’s no guarantee the problem will automatically get resolved. While regulators such as the SEC can enact bright, red-line rules about what is and is not permissible behaviour, we know from the course of history that human nature will push aggressive managers and organizations to continue to test new laws. Some managers will pursue questionable activity right up to technical conformity with the letter of the law, and some will step over the red line either directly or with crafty schemes and modern financial technology that facilitates deception.

The SEC and others like us can set the rules and define independence – but legal definitions can only go so far. And our free market, democratic system will

gradually erode, and inevitably suffer grievous harm, if remedial efforts are not undertaken and endorsed by a broad cross-section of our business and financial communities³⁵⁰.

Donaldson's speech makes it very clear that the effectiveness of public policies is very limited unless the business and financial communities provide an adequate level of commitment and endorsement³⁵¹

Chapter 11: Compliance and governance networks

16. Policy makers clearly attempt to constitute corporate "consciences" – getting companies "to want to do what they should do" – not just legally compliant outputs or actions, and meta-regulation – the proliferation of different forms of regulation (whether tools of state law or non-law mechanisms) each regulating one another – is a key feature of both contemporary corporate governance³⁵² and global governance³⁵³. The concept of

³⁵⁰ The full text of the speech is available on-line at <http://www.sec.gov/news/speech/spch101404whd.htm>.

³⁵¹Post, J., & Preston, L. (2012). *Private management and public policy: The principle of public responsibility*. Stanford: Stanford University Press.

³⁵²Cheffins, B.R. (2000). Current trends in corporate governance: going from London to Milan via Toronto. *Duke Journal of Comparative and International Law*, 10/5, 5–42.

³⁵³ See G20 Declaration Summit on Financial Markets and the World Economy (Washington, D.C.: November 15th, 2008, at 3-4; G20 Declaration on Further Steps to Strengthen the Financial System (London: September 4th – 5th, 2009); G-20 Toronto Summit Declaration (Toronto, June 26th – 27th, 2010) at 6-7; G20 Cannes Summit Final Declaration

meta-regulation³⁵⁴ can be fitted into a broader literature³⁵⁵ in which governance is seen as increasingly about “collaborations”, “partnerships”, “webs” or “networks” in which the state, state-promulgated law, and especially hierarchical command-and-control regulation, is not necessarily the dominant, and not the only important, mechanism of regulation. In fact, regulators are seeking the establishment of, and are prepared to offer significant incentives for, a more pro-active risk management function within companies and financial institutions. However good the laws and the legal system may be, if corporate behaviour is bad, legal risks will follow. Such a philosophy involves much more analysis of what companies themselves regard as significant risks and the appropriate measures to be taken to mitigate and manage them³⁵⁶, as recently echoed by U.S. President Barack Obama, who in a public speech on

(Cannes, November 4th, 2011) at 9-10; IOSCO, Final Report on the Subprime Crisis May 2008).

³⁵⁴Morgan, B. (2003). The economization of politics: Meta-regulation as a form of nonjudicial legality. *Social & legal studies*, 12.4, 489-523.

³⁵⁵ See C. Parker (2002). *The Open Corporation*. Cambridge: Cambridge University Press; J. Braithwaite (2003). Meta-risk management and responsive regulation for tax system integrity. *Law and Policy*, 25; Coglianese, C., & Lazer, D. (2003). Management-based regulation: prescribing private management to achieve public goals. *Law & Society Review*, 37, 691 (government as ‘meta-manager’); Grabosky, P. (1995). Using nongovernmental resources to foster regulatory compliance. *Governance*, 8, 527 (‘metamonitoring’). See also Baldwin, R. (2004). The new punitive regulation. *Modern Law Review*, 67, 351 and 374-82; Black, J. (2005). The emergence of risk-based regulation and the new public risk management in the United Kingdom. *Public Law:Autumn*, 512 and 543-5; Power, M. (2004). *The Risk Management of Everything: Re-thinking the Politics of Uncertainty*. London: Demos, 21.

³⁵⁶ See remarks by Governor Mark W. Olson to the Financial Services Roundtable and the Morin Center for Banking and Financial Services, Washington, D.C. May 16th, 2006: <http://www.promontorycs.com/images/Federal%20Reserve%20Governor%20Mark%20W.%20Olsen%20Remarks%2005.16.2006.pdf>.

financial regulation³⁵⁷ said that governments must make sure that “markets foster responsibility, not recklessness”.

17. States, businesses, non-governmental organisations and people operating even outside these three sectors may all be active in constituting various governance networks that steer (or attempt to steer) different aspects of social and economic life. States and law may be important to a greater or lesser extent in each of these networks, with overlapping forms of governance coming together in different ways to frustrate or accomplish various regulatory goals.

Chapter 12: Compliance and meta-regulation

18. The term “meta-regulation” itself has been used as a descriptive or explanatory term within the literature on the “new governance” to consider the way in which the state’s role in governance and regulation is changing and splitting. The state is regulating regulation as a consequence of policies to apply transparency, efficiency and market competition principles to itself (e.g., government units that assess the social and economic impact of regulation proposed by other departments before allowing new legislation to be proposed; regulating or auditing the quality assurance mechanisms of semi-independent government agencies, newly privatised or corporatized entities and government departments). “Meta- regulation” can also entail any form of

³⁵⁷ Remarks by the President on Financial Rescue and Reform, Federal Hall, New York, September 14 2009, available at: http://www.whitehouse.gov/the_press_office/Remarks-by-the-President-on-Financial-Rescue-and-Reform-at-Federal-Hall.

regulation (whether by tools of state law or other mechanisms) that regulates any other form of regulation. Thus it might include legal regulation of self-regulation (e.g., putting an oversight board above a self-regulatory professional association), non-legal methods of “regulating” internal corporate self-regulation or management (e.g., voluntary accreditation to codes of good conduct, etc.), the regulation of national law-making by transnational bodies (such as the EU), and so on. At a *domestic level* one generally finds clear examples of legal meta-regulation of corporate responsibility within specific domains of social and economic regulation of business. The most common method is through determinations of corporate liability, damages or penalties in civil or criminal law by reference to whether the corporation has implemented an appropriate compliance system³⁵⁸.

19. Meta-regulating law makes it a good legal risk management practice to implement processes to ensure internal compliance with regulatory goals. One of the oldest examples is probably the duty to provide a safe system of work in relation to occupational health and safety liability in tort and statutory regulation. The most famous is the US Federal Sentencing Guidelines for organisations, described earlier in this research, which state that the existence of an effective compliance system (as defined in the Guidelines) will provide companies or individuals with a reduction of penalty if they are found to have

³⁵⁸Bartle, I., & Vass, P. (2007). Self-regulation within the regulatory state: towards a new regulatory paradigm. *Public Administration*, 85.4, 885-905.

breached the law³⁵⁹. A variety of other regulatory liability regimes in the US are now predicated on similar considerations. In other jurisdictions, implementation of a compliance system is an important aspect in determining liability or penalties in relation to competition and consumer protection law, and vicarious liability for sexual harassment and discrimination or unequal employment opportunity. Recent UK and Australian corporate manslaughter disciplines could also be seen as examples of meta-regulation through the use of liability³⁶⁰.

19. The law might also seek more *indirect or partial methods of meta-regulation*. In fact, in this research's introduction, we have clarified that today's corporate compliance largely reflects a culture in which more is expected from companies, both in terms of regulatory complexity and in terms of controls previously carried out directly by the State. The age in which the State directly controlled compliance seems long gone. Often more indirect, less coercive³⁶¹ methods of meta-regulation are used (or proposed) for schemes aimed more at the ethical and discretionary aspects of corporate responsibility³⁶², or for schemes aimed at

³⁵⁹Hess, D. (2007). A business ethics perspective on Sarbanes-Oxley and the organizational sentencing guidelines. *Michigan Law Review*, 1781-1816.

³⁶⁰Rahim, M.M. (2012). Corporate governance as social responsibility: A meta-regulation approach to raise social responsibility of corporate governance in a weak economy. *Board Directors and Corporate Social Responsibility*, 145-167.

³⁶¹Black, J., & Baldwin, R. (2010). Really responsive risk-based regulation. *Law & Policy*, 32.2, 181-213.

³⁶²The World Health Organisation's *International Code of Marketing of Breast Milk Substitutes* is probably the most successful example of international regulation that applies to business organisations. It includes a primitive meta-regulatory aspect: 'manufacturers and distributors of products within the scope of this Code should regard themselves as

improving corporate responsibility as a whole (rather than focused on the goals of a specific regulatory regime). Several laws, such as the US *Sarbanes-Oxley Act* (2002), that require certain corporate employees to report suspected corporate fraud up to senior management and require or encourage companies to put in place whistleblower policies are a form of partial encouragement to internal corporate conscience³⁶³, since a corporate policy encouraging and protecting whistleblowers (generally in relation to any breach of legal or ethical obligations, not just financial fraud) would be one element of the sort of processes that companies would need to have in place to ensure their own responsibility. However, much more is also possible. Laws that simply protect whistleblowers (e.g., by providing that they should not be sacked or sued for their actions, and giving them the right to sue for compensation if they are sacked), rather than mandating implementation of policies, provide indirect encouragement to internal corporate conscience³⁶⁴. The availability of damages indirectly holds businesses accountable for allowing a culture or management system that ignores and punishes whistleblowers to go unchecked, and

responsible for monitoring their marketing practices according to the principles and aims of this Code, and for taking steps to ensure that their conduct at every level conforms to them’.

³⁶³An NGO the International Baby Food Action Network has been extremely active in monitoring compliance with the code (including the meta-regulatory provision quoted above) by Nestlé and other baby food companies (as well as governments), and enforcing it through social and political action. See Richter, J. (2001). *Holding Corporations Accountable: Corporate Conduct, International Codes and Citizen Action*. London: Zed Books.

³⁶⁴Beim, D., Hirsch, A.V., & Kastlelec, J.P. (2012). *Whistleblowing and Compliance in the Judicial Hierarchy*. Princeton: Princeton University working paper. Available at: SSRN 2141297.

encourages whistleblowers to make their concerns known³⁶⁵. Other examples might include government “approved” or sponsored voluntary corporate responsibility management accreditation and auditing schemes, voluntary undertakings to implement corporate responsibility management systems given to government and enforceable by contract, tax incentives, and government procurement decisions predicated on implementation of corporate responsibility systems.

20. Another technique of legal meta-regulation of corporate responsibility is when regulators “settle” potential regulatory enforcement actions with businesses only on condition that they implement internal changes to identify, correct and prevent future wrongdoing. Or, where courts make corporate “probation” orders that require the company to do so as part of the organisation’s sentence. The US Sentencing Guidelines state that organisations that do not have an effective compliance program should be placed on probation to implement one. Regulators in the UK and other Commonwealth jurisdictions have used discretionary powers to informally make settlements requiring compliance system implementation for years. Similarly, US prosecutors under a number of regulatory regimes consider whether a business has implemented an effective compliance program or not in deciding whether to prosecute or not. Another common method of meta-regulation is to make the implementation of internal corporate conscience mechanisms a condition of licenses or permissions required

³⁶⁵Edwards, J., & Wolfe, S. (2007). Ethical and Compliance-Competence Evaluation: a key element of sound corporate governance. *Corporate Governance: An International Review*, 15.2, 359-369.

before a company can engage in a certain business, or build facilities in a certain location. The most common examples are the environmental management systems and local community consultations often required as part of the licence obligations for permissions required from environmental regulators for manufacturing facilities³⁶⁶. License requirements for financial services firms usually include broad ranging internal systems for ensuring integrity of funds (preventing fraud, ensuring proper investment decisions, avoiding conflicts of interest, etc.) and investor disclosure³⁶⁷ (including consumer protection measures such as “know your client” principles) regulation³⁶⁸. Then there are a number of more voluntary meta-regulatory initiatives that seek to encourage or reward “beyond compliance” internal management systems³⁶⁹ by granting extra regulatory flexibility to firms that voluntarily adopt superior internal systems that go “beyond compliance” – for example, by fast-tracking the granting of permissions or licences to such firms, scheduling inspections less frequently for them, or providing public recognition for them through allowing

³⁶⁶Gunningham, N. (2011). Enforcing environmental regulation. *Journal of Environmental Law*, 23 (2), 169-201.

³⁶⁷Ford, C.L. (2008). New Governance, Compliance, and Principles-Based Securities Regulation. *American Business Law Journal*, 45.1, 1-60.

³⁶⁸Gunningham, N. (2009). Environment law, regulation and governance: Shifting architectures. *Journal of Environmental Law*, 21(2), 179-212.

³⁶⁹One partial example of meta-regulation at the transnational level is the *Basel Accord on Banking Regulation*, a voluntary multilateral agreement by which G10 nations agree to harmonised standards for national banking regulation. Under this accord, the robustness of banks’ internal systems for managing operational risk (a concept that includes breach of legal compliance requirements and reputational loss through breach of ethical obligations to stakeholders and other corporate responsibility failures) should be an element in deciding their capital adequacy ratios (the proportion of the investments they hold for customers that they must have available in cash in order to be able to operate).

them to use a seal or logo that is publicised as a mark of superior performance³⁷⁰.

³⁷⁰Coglianesse, C., & Mendelson, E. (2010). *Meta-regulation and self-regulation*. Penn Law School Public Law and Legal Theory, Research Paper no. 12-11.

Final remarks

“ If you think compliance is expensive, try non-compliance”³⁷¹.

Former Deputy US Attorney General Paul McNulty

* * *

0. In a closely connected business world, few issues affect corporate leaders and organizations as deeply as corporate compliance. This research has first dealt with the evolving contents of compliance in the context of a single corporate entity, where a gradient of intensity can be found across available literature. While compliance cannot be easily decoupled from corporate social responsibility in the public discourse and even in legal and managerial scholarship, compliance is not - only - a truism (a *“Binseweisheit”*) best practice or a “soft” law, but an obligation embedded in “hard” legal prescriptions. The nature of this obligation can be ascribed to a company’s top management set of obligations (it is a *“Fuehrungsausgabe”*) and to the duty of legality (*“Legalitaetspflicht”*) stemming therefrom. For organizational purposes, compliance can be delegated to corporate departments, but in any case the top

³⁷¹Friedman, T. L. (2005). *The world is flat: A brief history of the twenty-first century*. New York: Farrar, Straus and Giroux.

management does not free itself from the compliance duty nor loses its responsibility as a collegiate body. Based on a review of a vast body of international literature and case-law, this thesis shows that compliance is generally regarded as an “organizational duty”, i.e. as a duty to establish a risk recognition and pre-emption organization.

1. The law often grants discretion to corporate boards as to how and to what extent actually implement the compliance-derived organisational duty, and the corporate governance implications of this open-ended duty have been examined in part I and part III of this research against the backdrop of different corporate governance architectures and corporate bodies. In this respect, many risk-management-related rules are different from outcome-oriented or command-and-control regulations (substantive rules), as they provide a certain flexibility to companies to devise their own solutions to challenges. Several scholars argue, however, that this kind of risk management-related regulation facilitates misperceptions about what risk management can and cannot do. While risk management as a managerial tool is inherently imperfect, the very assimilation of risk management into regulation may have negative effects in two directions. First, *ex ante*, market participants, especially outside a company, may develop a sense of misplaced security over how much a firm’s management is in control of the outside world. The view that managing risk means having risks under control is obviously wrong, but it may only be natural to share it if risk management is legally and politically sanctioned and if firms heavily invest in it as a consequence. Second, *ex post*, risk management regulation may well generate an opposite misconception on the part of law

enforcers dealing with situations in which harmful events have materialized. If the law requires or expects adequate risk management policies and procedures, then it is easy to be led into thinking that, had those procedures been in place and complied with, no harmful event would have materialized, and hence that management or the board are at fault because their risk management procedures were below the minimal acceptable standard.

2. The discretion offered to boardrooms should never be interpreted too broadly: complying or not complying with the laws is in any case not subject to the discretion of the board, and cannot represent an opportunity for cost-opportunity analysis. At the same time, setting up efficient compliance organization and programs can be an important opportunity – and not just a legal obligation – for corporate boards. In fact, managers who implement effective measures to detect crime and who report wrongdoing can benefit their companies even if prosecutors do decide to indict. For instance, under the US federal sentencing guidelines and the Italian D. Lgs. no. 231/2001, a convicted corporation faces a significantly lower criminal fine if it had an effective compliance program, reported wrongdoing promptly, and cooperated than if it did not. If a company can prove that, before the crime was committed, it adopted and effectively implemented a model of organisation, management and control it is exempt from corporate liability under Italian law. Moreover, a corporation whose managers follow good corporate practices in deterring crime may avoid intrusive corporate probation. Finally, as testified by very robust bulk of managerial studies, in the face of public pressure or the threat of state regulation, being proactively compliant with rules and norms may be the most

rational strategy for business to evade the risks associated with adverse campaigning or public regulation. In fact, as argued in part III of this research, one the ironies of the recent era of deregulation business (in terms of state control) has been the simultaneous expansion of constraints imposed by civil society.

3. This research maintains that corporate officers who face a compliance duty engage in a collaborative effort with public enforcers. This is a key feature of so called “enforced self-regulation”, a scheme where the State provides a general but open-ended obligation, and leaves its implementation to the company’s top management and compliance officers. Based on existing case-law a compliance officer has a *sui generis* obligation. Indeed, he is obliged to avert criminal acts committed by employees of the organisation to the detriment of third parties. In fact it is not the compliance officer's primary duty to protect the company from attacks and damages, as is the case, for example, with auditing (preventing breach of trust and embezzlement at the company's expense) and measures for the protection of security of the works (preventing unauthorized persons from entering). Rather, compliance's duty - and, therefore, the employees' duty who work in that area - is the prevention of illegal acts having effect within the company (e.g. violation of regulations for the protection of employees) and outside of the company (e.g. cartel agreements or the use of company computers to exchange child pornography). The compliance officer can also take on additional tasks, such as a data security, money laundering or an export control officer. By accepting these duties compliance officers assume a special legal position, which distinguishes them

from the other employees within the company. Significant differences across jurisdictions have been detected as to whether the board and/or the compliance officer can be characterized as assistant public prosecutor (*"Hilfsbeamter der Staatsanwaltschaft"*). In Italy, for instance, the *Collegio Sindacale* can be considered as such, while this is not the case in Germany. Hence, it is controversial what happens in those cases in which the Compliance Department coincides with an Italian *Collegio Sindacale*, and whether the latter loses its status of guarantor of enforcement or the status of guarantor is extended to the compliance organization.

4. The challenges posed by compliance increase substantially in the context of a corporate group, and exponentially so in the context of a group whose business is carried out in a cross-border context. This research has in particular tried to advance research on the duties of group compliance, against the backdrop of multi-country regulatory diversity, private-to-private compliance obligations and organizational discretion. In fact, no law obliges a group to opt for a centralized group compliance or for a decentralized solution. More specifically, the task of a group compliance officer with a group-wide centralized compliance is a Sisyphean task. While a group is generally not regarded as a legal persona – unlike individual group companies – compliance shall ensure an efficient risk detection and pre-emption system that duly takes into account each country's specificity. Moreover, this research has found multiple and converging evidence that public prosecutors routinely seek to ascertain the role of the holding company within group architectures, and often hold them liable for violations taking place at the subsidiaries' level.

5. This thesis has tried to close a gap in existing literature by pointing out the limitations that should be considered when examining the duties of the international group compliance officer. Groups need to tailor their compliance programs to the international laws that apply to them. More specifically, these programs must comply with the foreign requirements and laws of all relevant jurisdictions where the companies do business. At first glance, this may seem like a daunting task. While it acknowledges several risks and duties associated with the task as group compliance officer, this thesis also conveys the message that his/her task should be relativized due to a number of factors. Firstly, the extension of compliance duty to the whole group, and hence to the parent company, is only possible if specific reasons are provided to demonstrate an active involvement of the parent company in the subsidiary's actions - the mere status of holding company is not enough. Secondly, one of the guiding principles of compliance management is that it should be commensurate to the complexity of the business and to its architecture, and in many cases compliance officers are merely obligated to report to the chief executive officer, so if they fulfill this obligation, there is no room for a liability based on omission. Thirdly, according to several commentators, the parent company's compliance officer advising group subsidiaries can be considered as an "external consultant". In such a capacity, the compliance officer is accordingly bound by confidentiality and attorney privileges, so conflicts can in particular arise when the group compliance officer is a lawyer and deals with group subsidiaries.

6. An important element that also contributes to relativize the role of a group compliance officer is the existence of restraints to the flow of information within a corporate group. As pointed out in this research, the access to information and data can sometimes generate conflict with data protection laws which exist in several foreign jurisdictions, and neither a board nor a compliance officer have legal powers to either override or disregard these laws.

7. Based on our research's findings, abundant international guidance exists that can help companies comply with international laws, such as the OECD's Good Practice Guidance on Internal Controls, Ethics, and Compliance, or the newly released ISO 19600 standard on compliance management systems. Yet, the existence of standards is not sufficient to overcome the complexity of regulatory diversity. In fact, a group compliance officer's business is also relativized by the absence of third-party certifications which could contribute to increase comparability of compliance organizations and processes across cross-border boundaries. In the absence of third-party certifications, it is still unclear how group compliance officers are supposed to prove their implementation of global standards to others. Therefore, it can well occur that a compliance officer is confronted with conflicting provisions, especially since the definitions are inconsistent and certainly this counteracts the aspired global standardization.

8. As this research is confined to the challenges of compliance in cross-border corporate groups, the review of the literature suggests that there is a wide range of issues that might have some impact on this area. In particular, a plethora of issues such as political, legal, cultural and social issues are likely

exogenous factors in this space. Another limitation of this research is that, having elements from different legal, managerial and policy environments, it is often difficult to build a parsimonious theory and theoretical specification. Consequently, generalisability of the findings is the most difficult aspect of this research approach. At the same time, this research provides several elements for future research. In particular, insofar as a robust body of literature and case law about cross-border compliance develops and cross-border cooperation among national enforcement authorities increases, the contours and duties of group compliance organizations will be defined more in-depth.

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