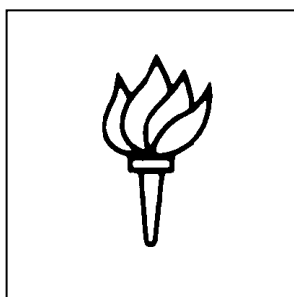


NEW YORK UNIVERSITY SCHOOL OF LAW

NYU Center for Law, Economics and Organization



The compliance function: an overview

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November 2014

LAW & ECONOMICS RESEARCH PAPER SERIES

WORKING PAPER NO. 14-36

The compliance function: an overview

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Abstract: The compliance function consists of efforts organizations undertake to ensure that employees and others associated with the firm do not violate applicable rules, regulations or norms. It is a form of internalized law enforcement which, if it functions effectively, can substitute for much (although not all) of the enforcement activities provided by the state. Together with its close cousins, governance and risk-management, compliance is an essential internal control activity at corporations and other complex organizations. This paper will examine the following topics: the analysis of compliance within a general theory of enforcement; the development of the compliance function; the concept of internal control; the distribution of the compliance function among control personnel; oversight obligations of directors and executives; compliance programs and policies; internal investigations; whistleblowers; criminal enforcement; compliance outside the firm; and business ethics beyond formal compliance.

Introduction

The compliance function consists of efforts organizations undertake to ensure that employees and others associated with the firm do not violate applicable rules, regulations or norms. It is a form of internalized law enforcement which, if it functions effectively, can substitute for much (although not all) of the enforcement activities provided by the state. The importance of compliance and the extent of liability for its failure have greatly increased over the past decades, both in the United States and in countries around the world. Together with its close cousins, governance and risk-management, compliance is an essential internal control activity at corporations and other complex organizations.²

The compliance function is embodied, in part, in the fiduciary duty of directors, whose obligation to direct the management of corporations includes the responsibility to guard against illegal activities. The corporate law of compliance, however, extends beyond fiduciary duties traditionally understood. It also includes substantive regulatory statutes, criminal laws, guidance from administrative agencies, codes of best practices, internal corporate rules, and other governing norms.

¹ Stuyvesant Comfort Professor, NYU Law School; Co-Director, Program in Corporate Compliance and Enforcement. I thank James Fanto for helpful comments.

² Legal scholarship on the law of compliance is as yet underdeveloped. Important early contributions include Jennifer Arlen & Reinier Kraakman, Controlling Corporate Misconduct: an Analysis of Corporate Liability Regimes, 72 N.Y.U. Law Rev. 687 (1997); Donald C. Langevoort, Monitoring: the Behavioral Economics of Corporate Compliance with Law 2002 Colum. Bus. L.Rev. 71 (2002). For recent work, see, e.g., Geoffrey Miller, The Law of Governance, Risk Management and Compliance (2014); Miriam Baer, Governing Corporate Compliance, 50 Boston College Law Review 949 (2009); Miriam Baer, Governing Corporate Compliance, 50 Boston College Law Review 949 (2009); James Fanto, Advising Compliance in Financial Firms: A New Mission for the Legal Academy, 8 Brooklyn J.Corp., Fin. & Comm. L. 1 (2013).

This chapter will examine the following topics: the analysis of compliance within a general theory of enforcement; the development of the compliance function; the concept of internal control; the distribution of the compliance function among control personnel; oversight obligations of directors and executives; compliance programs and policies; internal investigations; whistleblowers; criminal enforcement; compliance outside the firm; and business ethics beyond formal compliance.

1. Compliance in a theory of enforcement

At the most general level, compliance involves a tradeoff of costs and benefits. On the one hand, compliance can be a cheaper and more effective means to ensure that complex organizations obey applicable norms. The reason is that an external norm enforcer may not have the resources or the ability either to detect violations or to devise an effective system of sanctions. The organization has the knowledge and the ability to more effectively perform these tasks. It therefore makes sense for institutions to police themselves – to carry out a compliance operation.

On the other hand, because compliance delegates responsibility for norm enforcement to the organization, the external enforcer (regulator, prosecutor, etc.) loses some degree of control over the situation: It may be perilous to rely on an institution to police itself when the institution wants to flout the norm or to cover up violations. Accordingly, the external enforcer needs to monitor the compliance function to ensure that it is faithfully and effectively carried out – adding to aggregate social costs.

There is also a problem of incentives. When the external enforcer operates directly, rather than through a compliance program, the enforcer bears most of the costs of the enforcement activity. It has an incentive to perform in a cost-effective way. When, however, the external enforcer relies on internal compliance to enforce norms, the enforcer doesn't bear the costs of enforcement; these are imposed on the organization. Since the external enforcer doesn't internalize the costs of compliance, it may demand that the organization implement compliance operations which are costly but not particularly effective or necessary.

The job of policymakers is to devise a system which minimizes total costs of norm enforcement and norm violations. This task cannot be performed scientifically. Lawmakers are not structural engineers. When it comes to designing a compliance system much is done by intuition and guesswork. Nevertheless, in examining any given compliance system, we can still ask the basic questions: Does it draw the right line between internal and external enforcement; are the requirements appropriate, insufficient, or excessive; are there sufficient back-up lines of defense; and overall, does the chosen structure represent a reasonable tradeoff of costs and benefits.

2. Development of the compliance function

History has no beginning (other than the big bang). But often we can identify a provisional starting point. In the case of the compliance function, that point might be the Interstate Commerce Act of 1887, which created a federal administrative agency, the Interstate

Commerce Commission (ICC), to regulate the railroads. The Progressive Movement of the 1890s through 1920s, another important step in the development of compliance, reflected concern for eliminating corruption and enhancing the efficiency of government. Among its achievements were the Pure Food and Drug Act (1906), the Federal Reserve Act (1913), and the Clayton antitrust law (1914). The collapse of financial markets and the Depression of the 1930s led to the Banking Act of 1933, the Securities Acts of 1933 and 1934, and other regulatory enactments. More generally, this period witnessed a change in attitude on the Supreme Court, from one that resisted regulation of business to one that enthusiastically embraced it.

In more recent times, the rise of environmental concerns in the 1960s sparked a series of important federal statutes, including the Clean Water Act and the Clean Air Act, as well as the birth of a new federal administrative body, the Environmental Protection Agency. In the mid-1970s, revelations of American companies bribing foreign officials led to the Foreign Corrupt Practices Act in 1977. In the 1980s, the collapse of savings and loan institutions shook America's confidence in the integrity of the financial system and sparked legislation that upgraded banking regulation in many respects. The corporate scandals of the early 2000s, including spectacular failures of Enron and other firms, led to the enactment of the Sarbanes-Oxley Act (2002). The attacks of September 2001 focused attention on new threats to national security and triggered enhanced obligations to report suspicious activities and combat terror financing. Finally, the financial crisis of 2007-2009 undermined public confidence in banks and financial markets and led to a host of new regulations, including the Dodd-Frank Act of 2010.

These and other events punctuated what has been a broader and more "tectonic" change in American law. In the 19th Century, relations between corporations and the state followed a judicial model in which the government was required to prove its case in court like any other litigant. Due to changes in constitutional doctrine and administrative law, the judicial model no longer accurately describes the government's relationship with regulated firms. Governments today possess awesome powers of enforcement and authority to impose devastating penalties, often with only minimal judicial involvement.³

The contemporary law of compliance is profoundly influenced by these developments. Corporations faced with compliance problems are sometimes better described as supplicants seeking mercy from their regulators rather than as equal adversaries. Facing severe penalties for violations and significantly reduced powers to defend themselves in court, organizations have a strong incentive to internalize the law enforcement function by instituting procedures to guard against misconduct by their employees.

3. The concept of internal control

Compliance in is a form of internal control. The concept of internal control suggests that a well-managed organization is one in which assets and resources are effectively deployed to serve the purposes of the corporation. At one time in corporate history, a function of internal control was assigned to the corporate charter which would specify the purposes for which the

³ For skeptical analysis of the rise of the administrative state, see Richard Epstein, *Design for Liberty: Private Property, Public Administration, and the Rule of Law* (2011); Gary Lawson, *The Rise and Rise of the Administrative State*, 107 Harv. L. Rev. 1221 (1994).

firm was established and enumerate the powers it could exercise. Actions by a corporation that went beyond the purposes or powers so defined were *ultra vires* and wholly or partly unenforceable. In the modern corporation, however, purposes and powers restrictions have been all but nullified. The resulting gap has been filled by contemporary notions of internal control.

The leading statement of internal control in the modern business enterprise is set forth by the Committee of Sponsoring Organizations of the Treadway Commission (COSO), an umbrella of groups in the fields of accounting, auditing and financial management.⁴ COSO's *Integrated Framework* is the standard most public company auditors employ to evaluate management's assessment of the company's internal controls. COSO describes internal control as "a process, effected by an entity's board of directors, management and other personnel, designed to provide reasonable assurance regarding the achievement of objectives relating to operations, reporting, and compliance."⁵ Internal control, so defined, consists of the following components: control environment, risk assessment, control activities, information and communication, and monitoring activities.

As implemented within firms, the concept of internal control is embodied in the metaphor of the "Three Lines of Defense." The metaphor associates internal control with the process of defending territory from an external threat. It stresses the gravity of breakdowns in the internal control function; defines the threat as external to the organization; and offers reassurance that if control functions are properly designed and maintained, the threat of a breakdown can be kept within tolerable limits.

The first line of defense is the operating units and the heads of the entities, offices or divisions that carry out business activities. These people are named first because if they do not transgress applicable norms, the organization will not commit violations. But the metaphor also recognizes that the operating units cannot be relied on fully as a bulwark against violations, both because the line employees are not compliance professionals and because they may experience incentives to test limits in order to enhance their status or compensation.

The second line of defense consists of persons or offices charged with carrying out monitoring and control activities. Two second-line offices are most important: the senior official responsible for preventing and/or detecting violations of legal norms (chief compliance officer or general counsel); and the chief risk officer, whose job is to ensure that the risks undertaken by the line employees are consistent with the risk appetite established by the board of directors.

The third line of defense, which is supposed to catch problems that filter through the first two, is internal audit. The internal audit department is responsible for checking on the entire organization, including senior managers, in order to ensure that policies and procedures are being observed and shortcomings in the organization's internal controls are identified and promptly fixed.

⁴ See <http://www.coso.org/>. The principal author of the 2013 COSO framework is the global accounting and auditing firm PricewaterhouseCoopers.

⁵ Committee of Sponsoring Organizations of the Treadway Commission, *Internal Control – Integrated Framework* (2013).

The metaphor of the three lines of defense is useful, but also incomplete and inaccurate. It omits to mention other important controls that serve to catch and correct problems that get past internal audit: the board of directors (especially the audit committee), the external auditor, and, for regulated firms, the government supervisor. Even more broadly, the concept of control includes figures such as activist shareholders, proxy advisory firms, takeover bidders, and the financial press, all of whom, to one degree or another, monitor the behavior of the organization's managers. The metaphor of the three lines of defense also fails to capture the ambiguous role of the second and third lines, which are supposed to operate as independent checks on the business lines, but at the same are themselves part of the management team.

4. Distribution of the compliance function

As suggested in the concept of the three lines of defense, the compliance function is distributed across institutions rather than being centralized in any single person or office. The distribution of responsibility is often unclear and varies from organization to organization.

To address the lack of clarity as to role responsibilities, a United Kingdom reform proposed in 2014 would require banks to maintain and disclose a “management responsibilities map” describing how control functions are allocated across the firm, outlining reporting lines and lines of responsibility, and providing detailed information about senior managers and their responsibilities.⁶

In the United States, the Volcker Rule, which restricts proprietary trading by banks, requires large depository institutions to implement a framework that clearly delineates responsibility and accountability for compliance.⁷ As yet, however, the United States has not implemented more general requirements for disclosing the allocation of compliance responsibilities.

The Board of Directors:

It has always been clear that the board's responsibility for directing the management of a corporation includes a duty to oversee the activities of employees to ensure that they do not break rules.⁸ The contours of this fiduciary duty of oversight, however, have evolved over time. The business judgment rule, which protects directors against personal liability for actions undertaken in good faith, long appeared to provide a shield that protected directors in compliance cases. It is true that if a director failed to act as a director *at all*, the business judgment rule would not protect against liability.⁹ But if a director carried out even minimal responsibilities and did not willfully ignore evidence of illegal conduct, corporate law provided substantial immunity.

⁶ See Bank of England Prudential Regulation Authority, *Strengthening Accountability in Banking: a New Regulatory Framework* (July 2014).

⁷ Office of the Comptroller of the Currency, Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, and Securities and Exchange Commission, *Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds* (January 31, 2014), Subpart D.

⁸ E.g., Del. Gen. Corp. Law § 144(a).

⁹ *Francis v. Jersey Bank*, 432 A.2d 814 (1981).

This shielding of directors was problematic from the standpoint of public policy. The discretion afforded to directors under the business judgment rule is appropriate for ordinary business decisions because the incentives of shareholders align with the interests of society. In the case of compliance violations, however, illegal behavior might increase rather than reduce profits (an example is bribery to obtain lucrative contracts). In such cases, the business judgment rule threatened to immunize conduct inimical to the public interest. The problem became even more acute after Delaware authorized charter provisions that shield directors from monetary liability in duty of care cases.¹⁰

Delaware courts have attempted to remediate this problem. The theory, endorsed in *Stone v. Ritter*,¹¹ is that the director's duty of compliance is an aspect of the duty of loyalty, and therefore cannot be shielded by the business judgment rule or exculpated by charter amendment.¹² This duty requires directors to implement a "reporting or information system or controls;" and to "monitor or oversee" the operation of the system once implemented.¹³ The meaningfulness of these duties is undercut, however, by the leniency of the standard of care: directors are liable only if they utterly fail to implement a compliance program or consciously fail to monitor its operations.¹⁴ Delaware's approach to compliance thus has a curiously ambivalent quality: directors are subject to significant obligations, but are held liable only if they fail to manifest even minimal efforts.¹⁵ Although Delaware might be criticized as ineffectual, the state's approach arguably influences attitudes within the boardroom and empowers lawyers to encourage clients to upgrade compliance efforts.

In addition to liability for breach of fiduciary duty, directors may face exposure under regulatory statutes for failure to exercise oversight over compliance.¹⁶ As yet the scope of this more general oversight liability is unclear. Future cases may clarify which regulatory statutes can support oversight liability, whether oversight liability can be based on negligence, and in what circumstances members of boards of directors face liability for money damages under this theory.

While the full board is charged with assuring compliance, primary responsibility is often allocated to committees. The audit committee is most important. Often the audit committee charter includes a specific reference to compliance, and key officers in the second and third lines may have substantive reports to the audit committee rather than to a senior executive. Other committees also play a role in compliance. Some firms have established committees with

¹⁰ Del. Gen. Corp. Law § 102(b)(7).

¹¹ *Stone v. Ritter*, 911 A.2d 362 (Del. 2006). The original and still most important explanation of the board's oversight liability is *In re Caremark International Inc. Derivative Litigation*, 698 A.2d 959 (Del. Ch. 1996).

¹² See Claire A. Hill & Brett H. McDonnell, *Stone v. Ritter and the Expanding Duty of Loyalty*, 76 *Fordham L. Rev.* 1769 (2007).

¹³ *Stone v. Ritter*, 911 A.2d at 370.

¹⁴ *Id.*

¹⁵ Cases that generate liability tend to involve egregious facts and companies operated out of countries with poor reputations for corporate governance. See, e.g., *Rich ex rel. Fuqi Intern., Inc. v. Yu Kwai Chong*, 66 A.3d 693 (Del. Ch. 2013).

¹⁶ See *In the Matter of Steven A. Cohen*, S.E.C. Administrative Proceeding No. 3-15382 (2013). Although this action was not brought against a senior executive, the legal arguments would appear to carry over to proceedings against directors.

responsibility for compliance matters. The compensation committee can become involved because of the link between the incentives created by compensation arrangements and the propensity of managers to test the limits of legality. The nominating and governance committee may play a role, especially in cases where a member of the board or a senior manager is accused of wrongdoing.

The Management Team:

Some compliance obligations are imposed on senior managers as a team. Section 404(a) of the Sarbanes-Oxley Act requires that a reporting company's annual report must contain an "internal control report" which states "the responsibility of management for establishing and maintaining an adequate internal control structure and procedures for financial reporting."¹⁷ The report must also contain management's assessment of the effectiveness of these procedures.¹⁸ SEC regulations require reporting firms to "maintain disclosure controls and procedures" and "internal control over financial reporting."¹⁹ "Disclosure controls or procedures" are designed to ensure that the necessary information "is accumulated and communicated to the issuer's management, including its principal executive and principal financial officers, or persons performing similar functions, as appropriate to allow timely decisions regarding required disclosure."²⁰

The CEO:

The chief executive officer (CEO) is the public face of a firm – the living embodiment and symbol of the institution in the eyes of the public and its regulators. She is ultimately responsible for decisions the organization makes (subject to oversight by the board). Most importantly, from the standpoint of compliance, the CEO is responsible for setting the "tone at the top" – a culture, flowing from the highest management level, which endorses scrupulous adherence to applicable rules and norms. For this reason, even if only a relatively small percentage of her time is spent on compliance matters, the CEO is in a real sense the most important compliance officer in the organization.

Aside from the responsibility to establish a healthy tone at the top, CEOs have more specific compliance obligations. Section 302 of the Sarbanes Oxley Act requires the CEO and chief financial officer (CFO) to certify that a public company's annual and quarterly reports are not misleading and that the information included in the reports fairly presents the financial condition and results of operations of the issuer.²¹ In addition, the CEO and CFO must certify that they "are responsible for establishing and maintaining internal controls;" have "designed such internal controls to ensure that material information relating to the issuer and its consolidated subsidiaries is made known to such officers by others within those entities;" have

¹⁷ Sarbanes-Oxley Act § 404, 15 U.S.C. § 7262.

¹⁸ Id.

¹⁹ See 17 CFR 240.13a-15(a).

²⁰ Id. § 240.13a-15(e).

²¹ Sarbanes-Oxley Act § 302, 15 U.S.C. § 7241(a)(4).

“evaluated the effectiveness of the issuer's internal controls;” and have “presented in the report their conclusions about the effectiveness of their internal controls.”²²

The CEO and CFO must also certify that they have disclosed to the issuer's auditors and the board audit committee: “all significant deficiencies in the design or operation of internal controls which could adversely affect the issuer's ability to record, process, summarize, and report financial data and have identified for the issuer's auditors any material weaknesses in internal controls;” as well as “any fraud, whether or not material, that involves management or other employees who have a significant role in the issuer's internal controls.”²³ The signing officers must indicate “whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of their evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.”²⁴

A related provision, §906 of the Sarbanes Oxley Act, requires that an issuer’s periodic reports to the SEC be accompanied by a written statement of the CEO and CFO certifying that the information contained in the reports “fairly presents, in all material respects, the financial condition and results of operations of the issuer.”²⁵ Anyone who certifies a financial statement that does not comport with this requirement is subject to criminal penalties: up to ten years imprisonment if the officer acted “knowing that the periodic report accompanying the statement does not comport with all the requirements,” and up to twenty years if the officer acted “willfully.”²⁶

The Volcker Rule also contains a certification requirement: the CEO must attest that the company’s compliance program “is reasonably designed to achieve compliance with the rule.”²⁷

The Chief Compliance/Chief Legal Officer:

Many organizations employ a senior officer who has explicit authority for compliance. Traditionally, that officer was the in-house general counsel (GC). Many organizations continue to assign compliance to general counsels, but others have vested the responsibility in a chief compliance officer (CCO), who is usually but not always an attorney. The rationale for creating the CCO position is the inherent tension in the GC’s role: is the person charged with overseeing compliance supposed to be a zealous advocate for the organization’s interests in regulatory matters, or does she owe professional duties to a broader public? By separating the roles, organizations allow the GC to act with undivided loyalty to the client without being subject to potentially countervailing obligations to the public.²⁸

²² Id.

²³ 15 U.S.C. 1782(a)(4).

²⁴ 15 U.S.C. 1782a)(6)

²⁵ 18 U.S.C. § 1350(b)

²⁶ 18 U.S.C. § 1350(c).

²⁷ 12 CFR Part 248, Appendix B.

²⁸ For an argument for the continuing importance of the general counsel, see Norman Veasey and Christine T. Di Guglielmo, *The Indispensable Counsel: The Chief Legal Officer in the New Reality* (2012).

To what extent should the CCO act independently of the CEO and other senior executives? There are advantages and disadvantages to any arrangement. Requiring the CCO to report to another executive officer – the CEO, the CFO, the GC, or perhaps the chief risk officer (CRO) – has the virtue of centralizing management and bringing an advocate for compliance into the senior management team. On the other hand, making the CCO subordinate to other executive officials can be dangerous when the boss might herself be involved in a violation. Considerations such as these suggest that the CCO should be given a direct reporting line to the board of directors or to the audit or compliance committee, and that the CCO may also be given a degree of budgetary independence. One common solution is for the CCO to report substantively to the audit committee and administratively to an executive such as the CFO or CEO.

The CCO can perform her job effectively only if she has unfettered access to information about the firm. Organizations thus need to empower CCOs to expect full cooperation from others in the organization. In the case of mutual funds, such an expectation is guaranteed by law. SEC Rule 38a-1(c) prohibits an officer, director, or employee of a mutual fund or its investment adviser from taking any action to coerce, manipulate, mislead, or fraudulently influence the fund’s chief compliance officer in the performance of her duties.²⁹

The activities and powers of the CCO are generally defined in internal documents. In some cases, however, the law imposes non-delegable duties on these officials. For example, the Dodd-Frank Act’s rules regulating swap dealers requires the CCO to review and ensure the registrant’s compliance with the Commodities Exchange Act (CEA), to resolve conflicts of interest, and to establish procedures for remediation of noncompliance. The CCO must prepare and sign an annual report describing the registrant’s compliance with the CEA, the code of ethics, and the internal conflict of interest policy.³⁰

What happens if the CCO doesn’t perform effectively? In ordinary business settings, an officer who falls down on the job will face pay cuts, demotion, transfer, or dismissal. But these measures may not be effective in the case of the CCO, since that officer must monitor senior officials who determine the CCO’s compensation and authority. Addressing this problem, the SEC imposes supervisory liability on broker dealer CCOs who fail to prevent or detect wrongdoing. A difficulty here is an allegedly ineffective CCO may defend on the ground that they were not a supervisor of the culpable employee.³¹

The Chief Audit Executive:

²⁹ 17 CFR 270.38a-1(c).

³⁰ 7 U.S.C. §§ 6d(d), 6s(k).

³¹ See *In the Matter of Theodore W. Urban*, SEC Administrative Proceeding File No. 3-13655 (2010), available at <https://www.sec.gov/litigation/aljdec/2010/id402bpm.pdf>; SEC Division of Trading and Markets, *Frequently Asked Questions About Liability of Compliance and Legal Personnel at Broker Dealers under Sections 15(b)(4) and 15(b)(6) of the Exchange Act*, available at www.sec.gov/divisions/marketreg/faq-cco-supervision-093013.htm (opining that compliance and legal personnel are not per se supervisors, but that this status “depends on whether, under the facts and circumstances of a particular case, that person has the requisite degree of responsibility, ability or authority to affect the conduct of the employee whose behavior is in issue.”)

The internal audit function is carried out by a department within a firm. Internal audit departments are led by people with titles such as “Chief Audit Executive.” The head of internal audit often has a direct reporting line to the chief executive officer – a formal acknowledgement that the audit function is not subject to the control of any other department and a recognition that the head of internal audit has rights of access to the senior leadership. At the board level, the head of internal audit reports principally to the board audit committee.

What is the relationship between internal audit and the external auditor? On the one hand, the two operate at arm’s length. The external auditor reviews all aspects of financial controls, including internal audit. In this respect the external auditor is an independent and potentially exacting critic. On the other hand, internal audit typically cooperates in the external audit, reducing the independence of the two functions to some extent. External audit may also help empower internal audit in cases where others in the organization are impeding the latter’s work. In such cases, internal audit may find a way to get its needs met through the (more powerful) voice of the external auditor.

The Chief Risk Officer:

Many financial institutions and an increasing number of other organizations have created specialized risk management offices headed by a CRO. The CRO has an important, although indirect, role in compliance. Compliance risk is one of the most important threats facing an organization, and therefore a matter falling within the natural purview of the CRO. Accordingly, when an organization hosts both a CRO and a CCO, the two offices must operate according to a border treaty that establishes the boundary between their respective responsibilities.

5. Compliance programs, policies and contracts

The compliance function is implemented through compliance policies, programs and contracts. A compliance policy is a statement of an organization’s approach to ensuring adherence to its normative obligations, approved by the board of directors or other managing body, and announced internally and externally as representing the organization’s approach to carrying out this responsibility. A compliance program is a detailed statement of how the organization intends to carry out the obligations that it has recognized in its compliance policy. In addition to these internal documents, the compliance function increasingly involves a host of representations, commitments, rights and obligations contained in contractual agreements with counterparties, in areas as diverse as vendor risk management and supply chain due diligence.³²

Most large organizations have adopted compliance policies and compliance programs. There are many reasons for doing so. Such activities reduce board members’ potential liability under *Stone v. Ritter*. Implementing a robust compliance program can also shield managers from regulatory oversight liability. For example, the Securities and Exchange Act of 1934 contains a safe harbor protecting against supervisory liability if “there have been established procedures,

³² For valuable discussion, see Scott Killingsworth, *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 (2014).

and a system for applying such procedures, which would reasonably be expected to prevent and detect [violations].”³³

Organizations have other reasons to adopt compliance programs. In some cases, the law directly requires regulated industries to do so. An example is the Bank Secrecy Act, a law which seeks to combat money laundering and the financing of illegal activities. This statute requires banks to establish anti-money laundering programs with explicit compliance requirements.³⁴ The SEC has adopted regulations under the Investment Advisors Act and the Investment Company Act which require regulated investment companies and their advisors to create and maintain compliance programs.³⁵ The Dodd-Frank Act, likewise, requires swap dealers and major swap participants to designate a chief compliance officer who reports to the board of directors or CEO.³⁶

Corporations also establish or upgrade compliance programs as a result of regulatory enforcement actions. Settlements of regulatory enforcement actions often include undertakings to enhance compliance activities. A similar pattern is observed in criminal cases: prosecutors demand that targets upgrade compliance programs as a condition to deferred prosecution or non-prosecution agreements.³⁷ These programs, adopted in the shadow of enforcement proceedings, will not necessarily be the same as the ones that the firms would have chosen in the absence of an enforcement action. Among other things, settlement agreements often provide for the retention of a third party monitor to verify that the target fulfils its commitments.

Compliance programs are affected by private litigation. Shareholders derivative lawsuits challenging misconduct sometimes terminate in a settlement under which the company commits to implement “prophylactic” reforms to internal governance, often including reforms to processes of internal control. Compliance obligations may also be included in settlements of qui tam litigation brought by private parties in the name of the government. Less commonly, compliance-related settlements are negotiated in class action litigation challenging allegedly illegal conduct.

Firms also implement compliance programs in order to mitigate the severity of enforcement. Regulators consider an organization’s commitment to compliance when they decide whether to initiate enforcement actions. Federal prosecutors undertake a similar analysis: if a potential defendant has operated a compliance program and has cooperated wholeheartedly with the investigation, these factors will count in the decision whether or not to charge the entity.

An organization’s compliance-related conduct is also taken into account at the penalty stage. Among civil regulators, the Environmental Protection Agency is a leader in promising to mitigate the severity of sanctions if the defendant demonstrates sufficient cooperation and

³³ 15 U.S.C. § 78o(b)(4)(E).

³⁴ 31 U.S.C. 5318(h)

³⁵ SEC Rule 206(4)-7; SEC Rule 38a-1.

³⁶ 7 U.S.C. §§ 6d(d), 6s(k).

³⁷ For a skeptical evaluation of the role of prosecutors in corporate governance, see Jennifer Arlen, *Removing Prosecutors from the Boardroom; Deterring Crime without Prosecutor Interference in Corporate Governance*, in Anthony Barkow and Rachel Barkow, eds., *Prosecutors in the Boardroom* 267 (2011).

evidences a commitment to compliant behavior.³⁸ As for criminal conduct, the United States Sentencing Guidelines provide for credit in sentencing to organizations that operate effective compliance programs, even if the program in question failed to deter or detect the criminal conduct.³⁹

Conversely, an organization that implements a compliance program but then fails to administer it in an effective manner can suffer enhanced penalties. In 2011 the SEC rolled out a policy applicable to firms that are warned about deficiencies in their compliance programs, fail to correct the problem, and subsequently commit violations. The program encourages firms to adopt robust compliance programs because if they do not do so and are warned about the problem, they will receive especially harsh treatment in the event of a violation.⁴⁰

6. Elements of a robust compliance program

It is obvious that the mere creation of a compliance program will not ensure results. The program must also be effective.⁴¹

Perhaps the earliest statement of the requirements for a robust compliance program is contained in the Federal Sentencing Guidelines, promulgated in 1991.⁴² To qualify for potential reductions in sentencing, an organization must “exercise due diligence to prevent and detect criminal conduct; and otherwise promote an organizational culture that encourages ethical conduct and a commitment to compliance with the law.” The organization must establish standards and procedures to prevent and detect criminal conduct; ensure that its governing authority understands the content and operation of the program and exercises reasonable oversight over its implementation; conduct effective training programs; establish incentives to comply and disciplinary sanctions for noncompliance; and take reasonable steps to respond to the criminal conduct and to prevent repeat violations.

Other official pronouncements identify somewhat different ingredients of a robust compliance program. The Bank Secrecy Act specifies four elements: internal policies, procedures, and controls; a compliance officer; an employee training program; and an independent audit function.⁴³ The U.S. Department of Justice notes ten features: high level commitment to compliance; written policies; peer-based review; oversight and independence of compliance officers; training and guidance for employees; internal reporting; investigation; enforcement and discipline; oversight of agents and business partners; and monitoring and testing.⁴⁴ The SEC and Department of Justice, in joint guidance on foreign corrupt practices, identify the following factors: commitment from senior management; code of conduct and

³⁸ See Environmental Protection Agency, Incentives for Self-Policing: Discovery, Disclosure, Correction and Prevention of Violations, 65 Fed. Reg. 19,618 (Apr. 11, 2000).

³⁹ Federal Sentencing Guideline §8B2.1; §8C2.5(f).

⁴⁰ See, e.g., In re: Modern Portfolio Management, Inc., SEC File No. 3-15583 (2013), available at <http://www.sec.gov/litigation/admin/2013/ia-3702.pdf>.

⁴¹ See Geoffrey Miller, An Economic Analysis of Effective Compliance Programs, NYU Law and Economics Research Paper No. 14-39, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2533661.

⁴² Federal Sentencing Guideline §8B2.1, Effective Compliance and Ethics Program.

⁴³ 31 U.S.C. 5318(h)

⁴⁴ Remarks by Assistant Attorney General for the Criminal Division Leslie R. Caldwell (October 1, 2014).

compliance policies and procedures; oversight, autonomy, and resources; risk assessment; training and advice; incentives and disciplinary measures; third-party due diligence; confidential reporting and internal investigation; testing and review; and pre-acquisition due diligence and post-acquisition integration in mergers and acquisitions.⁴⁵

The Volcker Rule, jointly promulgated by federal banking agencies, requires that the compliance programs of mid-sized banks satisfy the following six elements: written policies and procedures; a system of internal controls; a management framework that clearly delineates responsibility and accountability for compliance; independent testing and audit of the effectiveness of the compliance program; training for trading personnel and managers; and making and keeping records sufficient to demonstrate compliance.⁴⁶ In the case of mega-banks, the rule mandates enhanced programs with more detailed policies, limits, governance processes, independent testing and reporting, and CEO attestation.⁴⁷

Several features of robust compliance discussions warrant further discussion. One is the idea of tone at the top. The concept is vague and indefinite, and it is all too easy for an unscrupulous CEO to mouth the right words while secretly subverting performance. Nevertheless, many government officials and compliance professionals view tone at the top as essential.⁴⁸ Part of the challenge of an effective compliance program is to signal the credibility of senior managers' commitment to compliant behavior.

Another key feature is controls over hiring. If an organization hires only employees of outstanding character, it is unlikely to run into compliance problems down the line. The problem is how to sort between good and bad candidates. People do not show up at the job interview bearing signs signaling the quality of their character. Human resources departments have developed a number of techniques to overcome this information asymmetry. The organization may investigate a job candidate's arrests, convictions, bankruptcies, credit scores, and employment history. The HR department may administer psychological assessments and may require employees and candidates to undergo drug or alcohol tests. These investigative techniques can be effective, but also pose legal risks. The organization must be careful not to cross the line into employment discrimination or illegal intrusions on privacy.

Another key feature of a robust compliance program is employee training. A robust program should inform traders, salespeople, and other employees about their obligations and – if possible – encourage them to internalize an ethical norm against shady dealing. Organizations devote considerable ingenuity to finding ways to ensure that the lessons conveyed during employee training have a real impact on behavior.

⁴⁵ U.S. Department of Justice and Securities and Exchange Commission, A Resource Guide to the U.S. Foreign Corrupt Practices Act (November 2012).

⁴⁶ Office of the Comptroller of the Currency, Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, and Securities and Exchange Commission, Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds (January 31, 2014), Subpart D.

⁴⁷ *Id.*

⁴⁸ On the relationship between institutional values and compliance, see Tom R. Tyler, Reducing Corporate Criminality: The Role of Values, 51 *Am. Crim. L. Rev.* 267 (2014).

Compliance programs may also include controls such as record-keeping, reporting, data analysis and sign-off requirements. Record-keeping creates an audit trail that internal audit or other investigators can use to check on potential violations. Compliance officers can use the power of “big data” to identify red flags of potential misconduct; a host of vendors offer software, systems, and services to assist firms in implementing such analytic methods. Sign-off requirements call a supervisor’s attention to decisions that might implicate compliance concerns, and operate as a check against uninformed or unethical behavior by junior staff.

Merely undertaking the steps described above is no guarantee that the program will function well. It is possible to establish a “paper program” that includes state-of-the-art compliance procedures but still operates ineffectively. Enron’s cutting-edge compliance program failed to prevent one of the largest frauds in American history (although, in fairness, it should be noted that Sherron Watkins, the Enron whistleblower, did take advantage of one feature of Enron’s program when she elevated concerns about the organization’s financial shenanigans to the highest management level).

7. Investigations

Once an organization has received evidence of a violation, it must determine what to do. In many cases, the next step is an investigation which seeks to ferret out the underlying facts. Some companies have spent millions or tens of millions of dollars a year in an effort to get to the bottom of potential violations.

Compliance investigations come in two general types. One concerns the routine violations that occur at any workforce. Typically, organizations have a set procedure for such cases. Investigations of minor misconduct are almost always conducted in-house, and may be undertaken by the human resources department under the direction of in-house counsel. The other type of internal investigation is the large-scale inquiry associated with violations that are serious, systematic, or likely to result in government enforcement actions. These investigations are often outsourced to law firms which specialize in the practice area; the reasons are that the organization may not have the resources in-house for such a major undertaking and that enlisting the aid of an independent attorney may induce leniency by the regulators. A downside of outside investigations is that organizations lose control of costs: having assigned a third party to perform the inquiry, they cannot afford to be seen as denying the investigators the resources needed to pursue their inquiry wherever it may lead.

A notable feature of internal investigations is the fact that employees enjoy few of the rights that would be afforded to them if the investigation were being carried out by the government. Private employers are not bound by constitutional norms. Further, because employees generally lack an expectation of privacy in the workplace, there are few limits on what the employer may scrutinize: the employer can read the target’s emails, monitor her web browsing habits, listen to her voice mails, train video cameras on her (in public spaces), confiscate her hard drive, interview her without disclosing that she is under suspicion, and deny her the right to counsel during such interrogations. Even worse, from the employee’s point of view, information obtained by the employer during such an investigation may be turned over to

the government, and can even be used by the organization as a strategy for obtaining leniency for itself.⁴⁹

Employees found to have committed a compliance violation will often be summarily terminated under circumstances that are hard to explain to other employers. They may lose their professional reputations. The emotional strains of investigation and punishment are likely to be high. They may experience a loss of benefits or a claw-back of compensation previously advanced. And while many who suffer these consequences have committed infractions that merit punishment, some who are innocent may find it difficult to clear their reputations.

8. Whistleblowers

Whistleblowers are key to compliance because they come forward with private information about violations. The potential advantage offered by such informants, however, is threatened by the powerful social norm against “snitching.”⁵⁰ No one likes a tattle-tale; and people who report compliance violations face retribution, not only from the people they expose, but also from others who enforce the social code. To counteract this problem, compliance programs typically provide an anonymous means for whistleblowers to communicate with senior officers, potentially including the CEO or the board audit committee chair, and also offer guarantees against retaliation. Some organizations have gone further and defined whistleblowing not only as a right but also as an obligation: all employees are required to come forward and report when they observe evidence of misconduct.

The phenomenon of whistleblowing is regulated by federal and state law. Typically, these laws offer protections against retaliation as well as compensation if retaliation occurs.⁵¹ Several regulatory schemes also provide bounties for people who come forward with evidence leading to enforcement actions. The SEC’s program authorizes payments to qualifying individuals who provide original information that leads to an enforcement action generating more than \$1 million in sanctions; qualifying individuals receive between 10 and 30 percent of the penalty.⁵² The Internal Revenue Service operates a similar program for persons who come forward with information about tax violations.⁵³ In the banking law area, the Federal Financial Institution Reform, Recovery and Enforcement Act of 1988 provides that private individuals may submit confidential claims of violations to the Department of Justice, which has twelve months to investigate. If the government responds by initiating enforcement proceedings, the whistleblower is entitled to between 20 to 30 percent of the first million recovered, 10 to 20 percent of the next \$4 million, and 5 to 10 percent of the next \$5 million.⁵⁴

Also important are “qui tam” actions. The False Claims Act, the most important qui tam statute, sets forth a procedure under which a private party (a “relator”) can file a lawsuit on

⁴⁹ For a critical analysis of internal corporate investigations, see Bruce A. Green & Ellen S. Podgor, *Unregulated Internal Investigations: Achieving Fairness for Corporate Constituents*, 54 B.C. L. Rev. 73 (2013).

⁵⁰ See Ethan Brown, *Snitch: Informants, Cooperators, and the Corruption of Justice* (2007).

⁵¹ See, e.g., 18 U.S.C. § 1514A; 15 U.S.C. § 78u-6(h)(1)(A).

⁵² Securities and Exchange Commission Regulation 21F, 17 CFR 240.21F-2.

⁵³ 26 U.S.C. § 7632; 26 C.F.R. 301.7623-1.

⁵⁴ 12 U.S.C. § 4205.

behalf of the government charging that a person has made a false claim on the government.⁵⁵ The relator must deliver a copy of the complaint plus supporting evidence to the government, which has 60 days to decide whether to intervene. If the government intervenes, it takes responsibility for the litigation although the relator retains the right to participate. If the government doesn't intervene, the relator may continue the case on her own. Relators receive a bonus if the litigation generates a settlement or judgment on the merits, ranging from 15 to 25 percent if the government intervenes to 25 to 30 percent if it does not. The relator is also entitled to attorneys' fees and costs.

9. Criminal enforcement

Criminal enforcement of regulatory norms is problematic. Organizations are not human beings; they cannot feel remorse or act with evil intent. They cannot be imprisoned or executed (other than by being put out of business). The most effective sanction against an offending organization is a fine; but fines can be obtained in civil enforcement actions without the high burden of proof and constitutional protections required in criminal cases. Why prosecute organizations, moreover, when prosecutions against individuals appear to be effective? And prosecutors have responsibilities other than enforcing compliance obligations – they need to deal with murderers, drug kingpins, and terrorists. Since civil authorities are available to enforce regulatory norms, would a prosecutor's resources be better directed elsewhere? Notwithstanding these objections, criminal prosecution is now well entrenched as one of the government's arsenal of weapons arrayed against regulatory violations.⁵⁶ So active are prosecutors, in fact, that commentators debate whether regulatory enforcement has become "over-criminalized."⁵⁷

A key issue in criminal cases is whether to initiate a prosecution. The Department of Justice's *Principles of Federal Prosecution of Business Organizations*⁵⁸ identifies factors that play a role in the charging decision. These include the nature and seriousness of the offense; the pervasiveness of wrongdoing; the organization's past history of offences; the value of cooperation and voluntary disclosure; the existence of a pre-existing compliance program; remedial actions undertaken by the organization; collateral consequences to third parties; the adequacy of prosecution against the individual offenders; and the availability of remedies such as civil or regulatory enforcement actions.

Criminal cases only rarely result in a verdict after trial. More often, prosecutors and the regulated party settle the dispute. Traditionally, settlement took the form of plea bargains in which the defendant pleaded guilty to a lesser offence. A problem with plea bargains is that the offender is generally required to admit its guilt.⁵⁹ Organizational defendants don't want to admit

⁵⁵ 31 U.S.C. §3730.

⁵⁶ For a justification of corporate criminal responsibility, see Samuel W. Buell, *The Blaming Function of Entity Criminal Liability*, 81 *Ind. L.J.* 473 (2006).

⁵⁷ See Lucian E. Dervan, *White Collar Overcriminalization: Deterrence, Plea Bargaining, and the Loss of Innocence*, 101 *Kentucky Law Journal* 543 (2013); Ellen S. Podgor, *Overcriminalization: The Politics of Crime*, 54 *American University Law Review* 541 (2005); Sara Sun Beale, *The Many Faces of Overcriminalization: From Morals and Mattress Tags to Overfederalization*, 54 *American University Law Review* 747 (2005).

⁵⁸ United States Department of Justice, *Principles of Federal Prosecution of Business Organizations* (2013).

⁵⁹ Pleas of *nolo contendere* which do not admit guilt are permitted by courts but disfavored by the Department of Justice.

to criminal behavior, both because doing so will damage their reputations and also because the plea may be used against them in subsequent civil litigation. In many cases, therefore, the need to admit guilt in a plea bargain will be a stumbling block to settlement.

To avoid this problem, the government has devised alternative remedies: deferred prosecution agreements (DPAs) and non-prosecution agreements (NPAs).⁶⁰ Because they are private agreements without a formal finding of liability, DPAs and NPAs do not involve judicial oversight and thus do not insert the court as an independent check on prosecutorial behavior. DPAs and NPAs may contain an agreed statement of facts but don't require an admission of guilt. Key to these agreements is the organization's commitment to cooperate with the government and to rectify control deficiencies. Often the agreement will set forth detailed obligations to establish or enhance compliance programs, policies and procedures.⁶¹

10. Compliance beyond the firm

Traditionally, the law of compliance has focused on a firm's internal norm enforcement activities. In recent years, however, law enforcement agencies and others have sought to enlist organizations to enforce norms against third parties. These cases of "compliance beyond the firm" can cause problems for the administration of compliance programs.

Consider the requirement under the Bank Secrecy Act for financial institutions to file Suspicious Activity Reports (SARs) with FinCEN, an agency of the Department of the Treasury. These reports are required whenever a transaction involves at least \$5,000 and the bank knows, suspects, or has reason to suspect that the transaction involves funds derived from illegal activities or is intended or conducted in order to hide or disguise funds or assets derived from illegal activities. . . ."⁶² The SAR filing requirement is an example of compliance beyond the firm because the bank is asked to facilitate the government's efforts to combat money laundering and terror financing.

Another example of compliance beyond the firm is the Foreign Corrupt Practices Act (FCPA), which prohibits firms with U.S. connections from bribing foreign officials.⁶³ While the statute is directed at corrupt activity by employees or agents of U.S. firms, it also has an obvious function of deterring corruption in foreign governments – a form of outsourced compliance.

Compliance beyond the firm has also become an issue in securities law. The SEC's "conflict minerals" rule requires companies that use "conflict minerals" – tantalum, tin, tungsten, and gold – to disclose to the Commission whether those minerals originated in the Democratic Republic of the Congo or an adjoining country.⁶⁴ If such materials did originate in the defined

⁶⁰ See Lawrence A. Cunningham, *Deferred Prosecutions and Corporate Governance: An Integrated Approach to Investigation and Reform*, 65 Fla. L. Rev. ____ (forthcoming), available at <file:///C:/Users/geoffreymiller/Downloads/SSRN-id2256624.pdf>.

⁶¹ See Christopher J. Christie & Robert M. Hanna, *A Push Down the Road of Good Corporate Citizenship: The Deferred Prosecution Agreement Between the U.S. Attorney for the District of New Jersey and Bristol-Myers Squibb Co.*, 43 Am. Crim. L. Rev. 1042 (2006).

⁶² 31 U.S.C. §5318(g) (2006); 31 C.F.R. §103.18(a)(2) (2006).

⁶³ 15 U.S.C. §§ 78dd-1 et seq.

⁶⁴ 15 U.S.C. § 78m(p); 17 C.F.R. §§ 240, 249b.

area, then companies must also submit an additional report to the Commission containing a “description of the measures taken ... to exercise due diligence on the source and chain of custody of such minerals,” and “a description of the products manufactured or contracted to be manufactured that are not DRC conflict free.”⁶⁵ An important purpose of this rule is to discourage companies from activities that could indirectly contribute to human rights abuses in the affected region.

11. Ethics beyond compliance

Organizations often include the term “ethics” in their compliance programs, promulgate codes of “ethics” that include a compliance component, and create positions such as “chief ethics officer” that include responsibility for compliance. As illustrated by these and other governance features, the law of compliance shares an uneasy boundary with a broader set of issues that might loosely be termed “ethics beyond compliance.”

Several factors explain the ambiguity in topic definition. First, the notions of a culture of compliance and tone at the topic cannot be strictly limited to formal legal requirements; otherwise the task of compliance could become synonymous with skirting legal regulations. Second, it may be advisable for an organization to place a “fence” around legal norms, thus helping to ensure that even if employees make mistakes they are unlikely to break the law. Third, the norms enforced by the compliance function include not only external rules but also internal norms. Self-imposed rules are often thought of matters of ethics rather than law (consider bar association ethics codes). Finally, organizations can benefit from the “good guy” image that ethical behavior beyond compliance can promote, either because the organization’s constituents obtain psychological benefits from doing the “right thing” or because a favorable public image may enhance sales, attract investment, deflect criticism, or deter enforcement actions.

Issues of ethics beyond compliance were problematic in an earlier era. Corporations were conceived of as exclusively profit-seeking enterprises that existed to serve the financial interests of shareholders. Such a firm could not make substantial gifts to charity without raising concerns that the donations were *ultra vires*. Early decisions on charitable gifts gave credence to this idea, at least when the gift was unusually large or general in scope.⁶⁶ More recently, corporate law has evolved to a point where gifts to charitable causes are clearly authorized.⁶⁷ Nevertheless there probably are limits beyond which a firm’s charitable activities could be called into question – either because the gift is large relative to profits or because an insider is seen as obtaining some special benefit.

Ethics beyond compliance has expanded beyond its initial grounding in charitable gifts. Permitted public interest goals include matters such as social responsibility, community empowerment, respect for human rights, sustainable environmental policies, labor rights, and other objectives.⁶⁸ Open any company website and you are likely to find a description of the

⁶⁵ Id. § 78m(p)(1)(A)(i)-(ii).

⁶⁶ Dodge v. Ford Motor Co.,

⁶⁷ Shlensky v. Wrigley, A.P. Smith Co. v. Barlow

⁶⁸ For discussion of some of these objectives, see Judd F. Sneirson, Green is Good: Sustainability, Profitability, and a New Paradigm for Corporate governance, 94 Iowa L. Rev. 987 (2009); Faith Stevelman, Global Finance,

various activities the firm is supporting to serve the public interest. State legislatures have also taken an active role. Many states now authorize “public benefit corporations” which serve the public interest as well as private profit.⁶⁹ A potential advantage of these companies is that they inform investors of their public interest goals; shareholders cannot claim unfairness or surprise when the company goes about seeking those goals at the expense of profits. It is too early to tell if public benefit corporations will have an important impact or to assess whether they will be subject to the same compliance obligations as apply to traditional profit-oriented firms.⁷⁰

Multinationals and Human Rights: With Commentary on Backer’s Critique of the 2008 Report by John Ruggie, 9 *Santa Clara J. Int’l L.* 101 (2011). For a somewhat more skeptical view, see Donald J. Kochan, *Corporate Social Responsibility in a Remedy-Seeking Society: A Public Choice Perspective*, 17 *Chapman L. Rev.* __ (2014).

⁶⁹ See J. Haskell Murray, *Social Enterprise Innovation: Delaware’s Public Benefit Corporation Law*, __ *Harv. Bus. L. Rev.* (2014); Lyman Johnson, *Pluralism in Corporate Form: Corporate Law and Benefit Corps.*, 25 *Regent U.L. Rev.* 269 (2012-2013).

⁷⁰ For discussion, see Joseph W. Yockey, *The Compliance Case for Social Enterprise*, University of Iowa College of Law Legal Studies Research Paper 14-23 (2014).