Global Corporate and
Antitrust & Competition Group

Milbank

Client Alert

Compliance on the Agenda – Again!

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In view of the recent initiatives of European and German legislators, identifying and, more importantly, preventing potential compliance issues is becoming more important. Compliance pressure on management is constantly increasing both through the recent discussions about the implementation of criminal sanctions for companies, as well as through significant personal liability risks. Recent legislative actions do not only address large, publicly listed corporations, but also small and medium-sized enterprises; immediate action is required to minimize risks. Compliance is no longer a "tick the box" task. It is an integral element of good corporate governance.

Whilst compliance obligations have often been developed through market standards and non-binding rules, legislators have meanwhile taken the lead and incorporated some of the components of a compliance management system ("CMS") into statutory law. Not only do legislators regulate the requirements of the internal design of good CMS, but also their extent and scope.[1]

I. German "Law on Strengthening Integrity in the Economy"

The "Law on Strengthening Integrity in the Economy" (including the "Corporate Liability Act"[2]), which is currently in the German legislative pipeline and shall take effect two years after its promulgation (i.e., expectedly 2023) aims to provide a legal basis for the (criminal) sanctioning of companies. Since the draft bill is subject to fierce criticism from various sides, some aspects might still change throughout the legislative process.

The draft bill stipulates that, simply speaking, sanctions on companies are to be implemented in two scenarios. First, if a manager ("*Leitungsperson*") of a company commits a criminal act himself by which the duties of the company have been violated or by which the company has been or is to be unjustly enriched; secondly, the manager did not prevent such a criminal act committed by a third party in performance of the duties for the company or did not make it substantially more difficult by taking appropriate and reasonable precautionary actions. Therefore, it is a precondition that the criminal act can be attributed to the company through the actions or omissions of the manager. Instead of using the

[1] As an example for a national act with potential global reach, see the German draft bill for a Supply Chain Law (so called *"Lieferkettengesetz",* currently in the stage of a government draft bill of March 1, 2021, (Link) to be discussed in and passed by the German Parliament) for the protection of human rights and environmental standards along the supply chain, complementing the ever more important compliance issues.

[2] "*Gesetz zur Stärkung der Integrität in der Wirtschaft",* including *"Verbandssanktionengesetz*", currently in the stage of a government draft bill of October 21, 2020, (Link) to be discussed in and passed by the German Parliament.

term “companies”, the draft bill generically speaks of “associations” (“*Verbände*”) as addressees of the provisions and thereby covers all kind of companies, irrespective of their legal form and size.

Fines of up to ten percent of the annual group turnover resemble the fines the European Commission or the German Federal Cartel Office (“FCO”) can impose on companies for competition law infringements. The current maximum fine of EUR 10 million (Sec. 30 OWiG) will no longer apply to large companies in the future. Besides significantly increasing potential fines, the draft bill subjects enforcement actions to the principle of legality. Hence, the competent authority no longer has discretion as to whether it goes after infringements known to it. It is obliged to enforce the law. Enforcement authorities are hereby equipped with a stronger mandate.

The draft bill intends to promote compliance measures and to provide incentives for companies to use internal investigations to help solve criminal offenses by taking into account the compliance actions of a company when setting a fine. A similar “compliance defence” had already been used by the German Federal Court of Justice (“FCJ”) in 2017 when it ruled that a CMS designed to prevent illegal behaviour can lower fines for companies, even if employees were able to behave illegally nonetheless.[3] According to the FCJ, in order to receive a full reduction of the fine, management must continue to consistently eliminate the weak points after the legal violations have been discovered.

A reduction of fines can also be achieved, if, inter alia, the company – similar to immunity programs which are widely used since long in competition law – takes efforts to uncover and investigate the offense. Also, full cooperation with the enforcement authority in the process of the investigation would be necessary (“cooperation defence”). This can lead to difficult decisions for a board that has a duty to act in the best interest of the company. Boards would be well advised to put standards in place which give guidance when enforcement authorities enter the field. Since timing is essential, standard routines should be developed and responsibilities clearly allocated. The decision whether to fully cooperate with the authorities or to defend against the allegations, sets the course at a very early stage of the procedure.

II. European Whistleblower Directive

In the same vein, further need for action results from the Directive on the protection of persons who report breaches of Union law (“Whistleblower Directive”[4]). The Whistleblower Directive, which has already entered into force, must be implemented into national law by the EU Member States. National provisions must be brought into force by December 17, 2021. In Germany, a draft bill of the Federal Ministry of Justice and Consumer Protection lays down the basis for the ongoing discussions.[5] Albeit being two formally different and independent pieces of legislation, there is significant interplay between the Whistleblower Directive and the Corporate Liability Act: whistleblowing is at the core of effective detection of infringements – a promotion of whistleblowing thus increases the risk of sanctions against the company under the new regime.

Upon implementation of the Whistleblower Directive, companies (irrespective of their legal form) with fifty or more employees (in certain cases even smaller companies with higher risk exposure) are obliged to establish internal reporting channels for persons reporting breaches of Union law. Whereas the establishment of a whistleblower system has always been part of good corporate governance, once the Whistleblower Directive is brought into effect, managers no longer have any discretion as to whether such reporting channels shall be established. Not only will they be legally obliged to do so, but also the modalities of the whistleblower system will be stipulated by statutory provision:

When instituting the reporting channels, companies must comply with the detailed procedures and timelines laid down in the Whistleblower Directive. For instance, they must ensure confidentiality of the

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[3] FCJ, Judgement of 9 May 2017, 1 StR 265/16.

[4] Directive (EU) 2019/1937 of the European Parliament and of the Council of 23 October 2019 on the protection of persons who report breaches of Union law (Link).

[5] “*Entwurf eines Gesetzes für einen besseren Schutz hinweisgebender Personen sowie zur Umsetzung der Richtlinie zum Schutz von Personen, die Verstöße gegen das Unionsrecht melde*n” as of November 26, 2020, (Link), to be discussed in and passed by the German Parliament.

identity of the reporting person and provide feedback to him or her within a reasonable timeframe. Employers must furthermore ensure that the persons entrusted with the tasks of the internal reporting unit shall be trained regularly for this task. Because competent authorities will review the companies' procedures for receiving reports, compliance should be ensured at all times. Again, penalties can be imposed if, for instance, the duty of confidentiality is not complied with.

Whilst the material scope of the Whistleblower Directive is restricted to an exhaustive list of legal areas of Union law that need to be covered after the implementation into national law (such as public procurement, financial services, money laundering, consumer protection or data protection laws), Member States may extend the protection of whistleblowers to national law. Along these lines, the German draft bill for the implementation of the Directive extended the material scope to the areas of criminal law – it covers the protection of whistleblowers who report any violation that is subject to criminal penalties or fines.

Due to their wide personal scope, both the Corporate Liability Act and the Whistleblower Directive also address small and mid-sized companies and will be an impetus for some of these companies to introduce a comprehensive CMS for the first time.

III. German Law on Strengthening the Financial Market Integrity

Against the backdrop of recent scandals in the financial markets, the German government initiated a draft bill of the so-called "Law on Strengthening the Financial Markets Integrity" ("*Finanzmarktintegritätsgesetz*", short "*FISG*"[6]). Amongst other goals, the FISG aims to strengthen good corporate governance. It therefore stipulates new obligations and specifies the duty of care of management boards of listed companies and will bring about several amendments to the German Stock Corporation Act ("*AktG*").

Being only "recommended" to date by the German Corporate Governance Code, management boards of listed companies for the first time will be obliged by the FISG to establish an effective and appropriate internal control system as well as a risk management system, both designed in the view of the company's business activities and risk situation. "Effective" shall mean that the system is capable of identifying, controlling and managing all material risks. So far, Sec. 91 para. 2 AktG obliges the management board of any stock corporation to institute a monitoring system (only) to identify developments jeopardising the company's continued existence. It remains to be seen whether the new provision (Draft Sec. 91 para. 3 AktG) will have an impact also on CMS. According to its wording, it only applies to internal control systems and risk management systems; however, there might be an overlapping impact on the design of CMS, too. Also, it is likely that the new provision will influence the market standard and thereby may get an impact also on companies that do not fall under the direct scope of the provision.

IV. German Act against Restraints of Competition

Some features which might be newly introduced by the Corporate Liability Act (see I, above) for all regulatory areas are already known from the German Act against Restraints of Competition ("ARC").

While the ARC in its amended version of January 2021 is mainly in the public focus for its new provisions concerning online platforms and the revised merger control thresholds, its new provisions regarding CMS are no less noteworthy. Pursuant to Sec. 81d para. 1 no. 4 and 5 ARC, when calculating fines for infringements of competition law, the German FCO must now consider reasonable and effective precautions taken to prevent and detect infringement (*ex ante*) as well as precautions taken after the infringement (*ex post*). In order to achieve a mitigation of fines, it is necessary that all objectively necessary precautions to effectively prevent violations of competition law are implemented.

[6] Currently in the stage of a government draft bill of December 16, 2020, (Link) to be discussed in and passed by the German Parliament.

Against the background of the recent judgement of the European Court of Justice, according to which financial investors can be held directly liable for their controlled portfolio companies' behaviour even if they are not aware of the infringing behaviour, investors are well advised to put antitrust and competition compliance considerations high on the agenda, both during the due-diligence prior to a transaction as well as after closing.[7] It remains to be seen whether this development will extend to other areas of law, especially those influenced by EU law.

V. Key Take-Away

The current regulatory initiatives are likely to have an impact on all market participants:

1. Large cap, listed companies that typically have sound CMS in place will have to ensure that their systems are in compliance with the new regulatory requirements, and that their CMS has sufficient reach within their groups. They also should put the creation of standards on their board´s agenda to be prepared for a compliance and/or cooperation defence in case of (alleged) breaches. They also are well advised to foster the importance of good governance and compliance, which are becoming increasingly relevant investment criteria and thereby can eventually determine the share price of the company.
2. Small and mid cap companies will find themselves in a position to introduce CMS for the first time at reasonable cost. Even for companies not listed on a stock exchange, compliance issues have high market relevance, e.g. in the M&A context, as investors increasingly focus on compliance issues, and due diligence findings in this area might not only have a negative impact on the purchase price.
3. Last but not least, board members themselves are well advised to treat compliance as a top-level matter. Their fiduciary duties require them to act in the best interest of the company and to avoid any damage to the company. So far, there is no clear case law as to whether or not a fine imposed on the company can be recovered from its board members personally. Compliance breaches and fines imposed by the authorities therefore always come along with the risk of damaging not only their company but also their private wealth.

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[7] For further details, see our Client Alert dated January 28, 2021 (Link).