



# Public Policy Alert

## Public policy impacting business

KPMG LLP

Issue 6 | October 2009

## Preparing for Increased Regulatory Oversight and Enhanced Enforcement

As regulatory authorities increase use of oversight and enforcement authority and penalties for noncompliance escalate, leading organizations are recalibrating their compliance and monitoring processes.

### Governance and oversight roles are impacted by mounting regulatory activity

The financial crisis has spawned new regulations and enhanced federal enforcement efforts in the American Recovery and Reinvestment Act of 2009 (ARRA or Recovery Act) and the Fraud Enforcement and Recovery Act of 2009 (FERA). The crisis, the authorization of hundreds of billions of dollars in new federal funding, and a desire to strengthen regulatory controls have combined to make scrutiny of potential fraud, waste, and abuse a mantra of the federal regulatory and law enforcement community. New standards for transparency and accountability provide a powerful incentive for companies to improve governance practices and related compliance and anti-fraud programs and controls. Whether an entity is a direct recipient of federal funding, a federal contractor, or

a public or private U.S. company hoping to avoid making headlines for legal or regulatory lapses, few businesses are exempt from the expanding oversight by federal regulators, and none should leave compliance to chance.

The adoption of ARRA, the creation of new federal programs, and the availability of economic stimulus funding have created newly regulated industries and modified the jurisdiction of various regulators for previously regulated industries. In this unpredictable economy, pressure for financial performance is mounting. Government programs and reforms bring complex mandates and requirements to an untested control environment and increase exposure to new risks. For some companies, a sudden influx of vast sums raises additional complications and a need for enhanced governance. The role of existing and new regulators is still evolving, as are the program

### Executives and Board Members Ask:

*"Are we ready for our regulator's new role?"*

- 1 Have we reevaluated the effectiveness of our compliance or ethics and conflict of interests programs in light of the new focus of our regulator and upcoming public policy changes? Are gaps in our compliance programs included in board agendas?
- 2 Do we evaluate and assess the root cause of any integrity concerns identified?
- 3 Do we use technology effectively to identify red flags?
- 4 How will internal audit plans be adjusted as a result of the current climate?
- 5 Do we provide fraud awareness and compliance training to key stakeholders?
- 6 Do we have a process for evaluating the effectiveness of controls and responding to deficiencies noted by regulatory agencies?
- 7 Is our company a direct recipient, subrecipient, vendor, or other party associated with the American Recovery and Reinvestment Act (ARRA or Recovery Act), TARP or TALF funding, or other government reporting? If so, have we adjusted our compliance programs to incorporate transparency and anti-fraud, waste, and abuse provisions?

requirements themselves, but corporate leaders and Board members should be asking themselves whether they understand how public policy proposals could affect their oversight role,<sup>1</sup> and whether they have considered the risk of ineffective compliance programs in their enterprise risk management process.

**Increased regulations and penalties escalate the need for comprehensive risk management**

FERA enhances law enforcement capabilities aimed at fighting fraud in a staggering array of areas receiving federal assistance, including mortgage lending, healthcare and pharmaceuticals, government contracts, procurement, government energy programs, education, government construction, securities and commodities, and financial institutions.

The Securities and Exchange Commission (SEC), in particular, has become increasingly active in its enforcement efforts. In the first seven months of 2009, the SEC Division of Enforcement filed nearly 30 percent more actions than it did in the same period in 2008.<sup>2</sup> The Enforcement Division also announced it would be creating specialized units to focus on complex major regulatory enforcement in areas such as asset management, market abuse, structured and new products, foreign corrupt practices, and municipal securities and public pensions.<sup>3</sup>

Cataloging all of the actual and potential new rules, regulations, and areas of heightened scrutiny by regulators is challenging, but a short list of areas of new or increased regulatory focus that encompasses all industries includes the following:

- The Department of Justice has further increased antitrust enforcement<sup>4</sup> and is vigorously pursuing violations of the Foreign Corrupt Practices Act (FCPA).<sup>5</sup>
- The Department of Labor increased staff for investigation of wage and hour disputes.<sup>6</sup>
- The Department of Health and Human Services authority<sup>7</sup> now exposes companies to potentially significant civil and criminal penalties for violation of data privacy and security rules governing the protection of protected health information, which appears in many healthcare and non-healthcare activities such as self-funded health plans, medical malpractice information, medical insurance claims, or benefit plans.
- The Commodity Futures Trading Commission and the SEC are considering limiting “speculative” trading in commodities markets, and have recently withdrawn “no-action” letters that granted relief from speculative position limits.<sup>8</sup>
- The Treasury Department has appointed inspectors general to enforce transparency rules, increased audit requirements for the single audit, and provided broad authority to the special inspector general (SIGTARP)

**Regulators’ New Role Focuses on Detection and Prevention**

*“A strong and reinvigorated SEC will be on the beat like never before to catch wrong doers. But there needs to be a new era of responsibility on Wall Street and throughout our markets to ensure that wrongs don’t occur in the first place.”*

Mary Schapiro, Chair, SEC, February 6, 2009

<sup>1</sup> “Public Policy Alert: SEC’s Proposed Rule Would Reshape Disclosure of Compensation Policies, Governance Structure and the Board’s Role in Risk Oversight,” KPMG, LLP, August 2009.

<sup>2</sup> The Division has opened approximately 10 percent more investigations, granted 118 percent more formal orders, filed 147 percent more temporary restraining orders since May of 2008.

<sup>3</sup> Robert Khuzami, the director of the Enforcement Division, recently stated, “SO if your client has broken the law, and has not provided the requisite level of cooperation, don’t expect leniency. Arguments such as your client is a ‘good guy,’ or ‘our competitors do it,’ or ‘we’ve always done it this way,’ will not be credited.” Speech to the New York City Bar Association, August 5, 2009.

<sup>4</sup> Vigorous Antitrust Enforcement in This Challenging Era, Christine A. Varney, Department of Justice, May 11, 2009 <http://graphics8.nytimes.com/images/2009/05/12/business/VarneySpeech.pdf>.

<sup>5</sup> Prepared remarks to the National Association of Criminal Defense Lawyers at the Fifth Annual “Defending the White Collar Case – In and Out of Court” Seminar, Lanny A. Breuer, Assistant Attorney General, Criminal Division, October 1, 2009. <http://www.usdoj.gov/criminal/pr/speeches/2009/10/10-01-09breuer-speech.pdf>.

<sup>6</sup> US Department of Labor, press release 09-0324-NAT, March 25, 2009.

to direct the Troubled Asset Relief Program (TARP) recipients' use and reporting of funds.<sup>9</sup>

- The administration has stated its intention to influence consumer protection directly through a new regulatory body called the Consumer Financial Protection Agency (CFPA).<sup>10</sup>
- Amendments to the Federal False Claims Act expand potential liability to recipients of almost all federal funding, including ARRA funds, and provide enhanced protections to whistleblowers.

The adoption of the ARRA has similarly resulted in an increase in both law enforcement and regulatory activity and oversight. As noted above, the SIGTARP has been both vocal and active in its oversight efforts as befits an organization whose mission statement reads "advance economic stability ... through transparency, through coordinated oversight, and through robust enforcement against those, whether inside or outside of government, who waste, steal or abuse TARP funds."<sup>11</sup> According to a recent TARP report, SIGTARP had 35 criminal and civil investigations running the gamut from securities fraud to mortgage fraud to tax investigations.<sup>12</sup>

Only a month after the Recovery Act became law, Earl Devaney, chair of the Recovery Accountability and Transparency Board, observed, "I'm afraid that there may be a naive impression that given the

amount of transparency and accountability called for by this act, no or little fraud will occur. My 38 years of federal enforcement experience tells me that some level of waste and fraud is unfortunately inevitable."<sup>13</sup> Following that view, the inspectors general of almost all federal agencies have increased their staffs with additional funds available through ARRA and have been vocal about enhancing and implementing additional anti-fraud programs and controls to carry out their mandate.

### **The growing importance of compliance programs – prevention is key**

Leading organizations are now considering how they may be at risk for incidents of fraud or misconduct, whether related to receipt of funding under ARRA or as a result of the reality of increased scrutiny by the DOJ, SEC, or others. As organizations face pressure for financial performance in an unpredictable economy, faster reporting deadlines with more complex new mandates, and, in some cases, a sudden influx of government capital, they are considering what new controls may be necessary. As companies want to achieve compliance with new anti-fraud laws and regulations, their agendas should center on efforts to:

- Understand fraud and misconduct risks that can undermine their business objectives
- Reduce exposure to corporate liability, sanctions, and litigation
- Achieve the highest levels of business integrity through sound corporate governance, internal controls, and transparency.

### **Corporate Leaders Increasingly Concerned about Managing Internal Fraud**

A recent KPMG fraud survey indicates that over the next twelve months, over 70 percent of executives surveyed fear the potential loss of public trust, and the majority of the executives surveyed consider fraud and misconduct significant risks to their industries.

Yet two-thirds of executives reported that organizations are unable to check fraud and misconduct due to inadequate internal controls or compliance programs. About one-third lacked protocols on how to remedy control breakdowns.

The common denominator in response to this unprecedented level of regulatory scrutiny has been to increase prevention and compliance efforts.

Forensic Fraud Survey 2009, KPMG LLP, 2009

<sup>7</sup> Under the Health Information Technology for Economic and Clinical Health (HITECH) Act, an amendment to the Health Insurance Portability and Accountability Act (HIPAA). "Interim Final Rule" effective September 23, 2009.

<sup>8</sup> US Commodity Futures Trading Commission Release 5695, August 19, 2009.

<sup>9</sup> You "can't push out \$3 trillion without someone taking advantage of it." Neil Barofsky, SIGTARP, "TARP Enforcement: The New Regulatory Regime" Seminar, July 28, 2009, presented by KPMG LLP and Willkie, Farr & Gallagher LLP.

<sup>10</sup> Public Policy Alert: Financial Regulatory Reform Focuses on Broad Frameworks to Consolidate Financial Risk Management and Consumer Protection Authority, KPMG, LLP, June 2009.

<sup>11</sup> <http://www.sig tarp.gov/index.shtml>.

<sup>12</sup> SIGTARP Quarterly Report to Congress, July 21, 2009.

<sup>13</sup> Recovery Accountability and Transparency Board minutes, March 12, 2009.



### Increased regulator oversight underscores business concerns

Fraud and misconduct are top of mind for many leaders for whom the greatest concern is the potential loss of public trust when market confidence is at a premium. Even before FERA and other enhanced enforcements were in place, a broad fraud study<sup>14</sup> indicated that a third of executives expect an increase in at least one of the fraud categories identified in the survey over the next twelve months. Compliance needs cited for improvement included employee communication and training, technology-driven auditing and monitoring, and fraud and misconduct risk assessment.

Rigorous compliance and anti-fraud programs are marks of leading boards and management that are endeavoring to identify and address potential problems before they erupt. Given the escalating penalties for the disclosure of inaccurate information or information that is harmful to the organization, many executives are anticipating their compliance needs and reevaluating their processes for collecting and reviewing disclosures. In general, fewer resources are needed to prevent fraud, waste, and abuse than to redress the business disruptions and reputation damage that inevitably occur in the aftermath of a problem—even a seemingly minor one.

Leading organizations should take steps to evaluate the implications of this new enforcement environment and modify or enhance compliance efforts accordingly. As new efforts designed to improve transparency take hold, both regulators and shareholders are rapidly gaining additional access to information and have heightened expectations of new levels of accountability in corporate governance.

### Business-driven Fraud Risk Management

The key objectives in an effective, business-driven fraud risk management approach are prevention, detection, and response.

- **Prevent.** Reduce the risk of fraud and misconduct from occurring
- **Detect.** Discover fraud and misconduct when it occurs
- **Respond.** Take corrective action and remedy the harm caused by fraud or misconduct

An ongoing process typically has four phases:

- **Assess Risks.** Identify the scope of the analysis and key stakeholders, profile the current state of fraud risk management, set targets for improvement, and define steps necessary to close the “gap”
- **Design.** Develop a broad-ranging program that encompasses controls to prevent, detect, and respond to incidents of fraud or misconduct
- **Implement.** Deploy a strategy and process for implementing the new controls throughout the organization and assign responsibility for leading the overall effort to a senior individual
- **Evaluate.** Assess existing controls compared with legal and regulatory frameworks as well as leading practices, such as internal investigation protocols or due diligence practices

<sup>14</sup> Forensic Fraud Survey 2009, KPMG LLP, 2009.