

## LEGAL AND COMPLIANCE RISK IN A GLOBAL WORLD: NEMESIS OR CATHARSIS?

Peter Kurer

### AUTHOR

*Peter Kurer is a partner with the private equity firm BLR. He studied law and political science at the University of Zurich and the University of Chicago, and started his professional career with the international law firm Baker & McKenzie, where he became a partner in 1985. In 1990, Peter Kurer was a founding partner of the Zurich law firm Homburger, where he headed the corporate law practice group. He specialized in M&A and corporate law and also served on a number of boards of public and private companies. In 2001, Peter Kurer joined UBS as general counsel and member of the group executive board. He served as chairman of the bank during the crisis of 2008–2009 and then retired. He also is chairman of Swiss book publisher Kein & Aber, sits on a number of boards and acts as an independent adviser. Peter Kurer writes and speaks frequently on M&A topics, corporate governance issues, and legal and compliance risk management. His new book, *Legal and Compliance Risk: a Strategic Response to a Rising Threat for Global Business*, was published by Oxford University Press in February 2015.*

## TABLE OF CONTENTS

I.	INTRODUCTION	6
II.	ROOT CAUSES	7
III.	FROM BUREAUCRAZY TO STRATEGY	10
IV.	A ROADMAP TO LEGAL RISK MANAGEMENT	11
V.	DEFINING THE STRATEGY	12
VI.	CUTTING EDGE: TECHNOLOGY AND NUDGING BEHAVIOR	13
VII.	CONCLUSION	15

## I. INTRODUCTION

Legal and compliance risks are the most serious threat to the smooth operation of global business. Every day, we read headline news about huge fines, investigations, prosecutions, massive litigation, and other legal evil hitting the icons of global finance and global industry. Since the banking and finance crisis, banks and other financial institutions have paid more than USD 230bn in terms of fines to a number of governments, an amount which equals the regulatory capital of four to five really large global banks. The financial industry often dominates the public debate but breathtaking legal hits are by no means an exclusivity of the banks. In the wake of the dot-com crisis, a number of big corporations simply disappeared in a cauldron of legal issues, and the once mighty and shiny accounting firm Arthur Andersen followed them mainly because it mishandled its document retention policy. Also, after the bursting of the dot-com bubble, and other than in the banking crisis, many high ranking executives went to jail, and a number of them with de facto life terms. Apart from these cases, arguably, the largest materialization of legal risk might be the Deepwater Horizon disaster of BP in the Gulf of Mexico. BP recently reached an USD 18.7 billion settlement with a number of US federal, state, and local authorities over this oil spill. This brought the total liability of BP for it to USD 54 billion, and this number will still increase over the months and years to come. The legal fall-out of the Deepwater Horizon disaster almost broke the neck of one of the strongest companies in the world and bears witness to the simple fact that legal issues might not only bring vulnerable and fragile banks to their knees but also rock-solid oil companies.

Events like these have left a lasting impression on the minds of senior business leaders and impact the way they think. To put it in the simplest terms: senior business executives see now legal, compliance, and regulatory risk as the most serious threat and uncertainty in their entrepreneurial activities. This has been proven by much empirical data. A research study published by Accenture in the year 2013 showed that global companies see legal risks as the number 1 external pressure on their operations; moreover, regulatory risks were the third most often mentioned risk class.<sup>1</sup> These results are supported by a number of other surveys undertaken, e.g., by PA Analysis, BLP, and others.<sup>2</sup> We can safely conclude that legal, compliance, regulatory, liability, and related risks now outweigh the classical business risks such as economic, technological, or environmental uncertainties. Thus, often, these risks are the modern time *nemesis* for global companies.

---

<sup>1</sup> Accenture, 'Risk Management for an Era of Greater Uncertainty', Accenture 2013 Global Risk Management Study, <http://www.accenture.com/microsites/risk-management-research/2013/Pages/home.aspx>, p 9.

<sup>2</sup> Michel Syrett and Marion Devine, *Managing Uncertainty* (London: Economist & Profile Books, 2012) pp 13f; Berwin Leighton Paisner, 'Legal Risks Benchmarking Survey' (11 October 2013), <http://www.blplaw.com/expert-legal-insights/articles/legal-risk-benchmarking-report/>, p 2.

But have these companies learnt how to bring this emotional threat up to the level of *catharsis* where they could experience relief from it, allowing them to get confidence that they understand these risks and can reasonably manage them. The simple answer is, no: Whilst company executives in the above mentioned surveys see a high exposure in terms of legal risks they are not convinced that they master these risks. A study by the English law firm BLP concluded that legal risk is poorly understood outside of the general counsel's office; only 25 per cent of chief executives and company directors actually said that they have a clear understanding of these risks.<sup>3</sup> Also, in a related way, research undertaken by leading behavioral economists shows that boards and senior managers hold too optimistic views on the level of compliance within their organizations.<sup>4</sup>

Thus, we are confronted with a paradox: whilst legal and compliance risks epitomize the modern nemesis for global companies these companies are a far cry from catharsis. Obviously, as we know, most global businesses invest huge efforts and capital into the management of legal and compliance risks. Many companies have achieved a high level of competence in this space. But even those who are good in these matters remain haunted by legal issues.

I believe that this paradox needs a strategic response which goes much beyond of what is discussed amongst lawyers, compliance specialists, and many other experts. This strategic response has many facets. I have discussed them in depth in my recent book on managing legal and compliance risk.<sup>5</sup> I will summarize a few of my views in the following paragraphs.

## II. ROOT CAUSES

Every strategy starts with knowing the root causes of a problem. This simple requirement is often overlooked even by those who hold responsibility to advise on, and mitigate, legal risk. They sometimes hold surprisingly naive views of what makes the legal world complicated. I recently talked to a well-versed lawyer who educated me that legal risk has mainly increased because there are more and more new laws and rules. Is this an answer or only a superficial description of the phenomenon itself? Similarly, politicians, regulators, the media, or even some academics often reduce compliance failures to the concept of misbehaving, an understanding that everything would be fine if only the boards and senior managers would be more ethical, less greedy, and better in how they set the tone and culture at the top.

---

<sup>3</sup> Berwin Leighton Paisner, 'Legal Risks Benchmarking Survey' (11 October 2013), <http://www.blplaw.com/expert-legal-insights/articles/legal-risk-benchmarking-report/>, pp 1 and 6.

<sup>4</sup> See Peter Kurer, *Legal and Compliance Risk* (Oxford: Oxford University Press, 2015), p 247.

<sup>5</sup> Peter Kurer, *Legal and Compliance Risk* (Oxford: Oxford University Press, 2015).

As a matter of fact, the answer is much more complex than just more laws or a lack of ethics of businesspeople. In reality, there are huge sociological, technological, and economic changes in our world behind the rise of legal risks in recent decades. The main root cause of the astonishing increase of legal risk for global companies lies in globalization – or rather the technological changes and inventions which have enabled and driven the remarkable push of globalization as we have seen it in the last thirty years. First came the reduction in transportation and communication costs by the invention of container shipping and satellite transmission, then the internet, the World Wide Web, Windows, and the exponential growth of computing power enabling Big Data and the Cloud, and finally the concept of remote computing and control. These and other technologies, which did not exist when my generation went to university, have created a world that Tom Friedman ably called a “Flat World”.<sup>6</sup> Nowadays, big companies do not only trade with remote places (which they did since ancient times); they invent in one place and produce in another; they sell products by a mouse-click around the globe; they produce one part of a product in one place, another in a other place. The new emerging global company works and operates everywhere.

There is a very simple problem attached to all of this: many legal systems will govern any kind of activity of a global company in parallel. We call this legal pluralism and some observers rightly say that this has gone far beyond a battle of different legal rules and reached a situation which one might call legal postmodernism – describing a world where the rational concept of law is deconstructed much like a building made by Richard Gehry or a novel written by Alain Robbe-Grillet.<sup>7</sup> This is a world where the law has become an amorphous and entropic system, where one is often hit by its force by pure happenstance.

The operation of this globalization chaos is reinforced – and multiplied – by a number of other factors:

- Our world is a completely transparent one by now - thanks to ever present electronic and social media, a hyperactive blogosphere scandalizing every global misdeed within minutes, and Big Data, as well as through such regulatory developments like the establishment of the true and fair accounting standards, disclosure and self-reporting requirements. The public eye sees now everything. Global businesses cannot hide anywhere, and they cannot hide anything.
- The world witnesses a growth of multi-pluralism and multi-culturalism. Due to globalization, migration and the laws of total transparency, people and ideas move easily. This has an effect on the legal and political system in many ways: handshakes and natural trust do not count anymore, mistrust is pervasive, doc-

---

<sup>6</sup> Thomas L. Friedman, *The World is Flat* (New York: Farrar, Straus and Giroux, 2005).

<sup>7</sup> See Sionaidh Douglas-Scott, *Law after Modernity* (Oxford and Portland: Hart Publishing, 2013).

umentation gets more extensive and expensive, new laws are created to please minorities, NGO ask for *social responsibility* favors for the benefit of their clients, and prosecutors and even judges often react to public sentiments or based on their own cultural values rather than they would apply the law in an unbiased way.

- In many ways, the world has become a *Risk Society*.<sup>8</sup> It can be better understood in terms of risk allocation than in terms of wealth distribution. In this Risk Society people have become very sensitive to risks which, amongst others, are created by global business such as nuclear power plants, oil spills, or financial instability. They ask for, and get, more regulation and legal control of business.

As a result of all this, the quality of the relationship between law and governments has changed in many ways. We all have been raised in concepts of rules of law, due process, and separation of powers. But in many quarters of the world these concepts are not accepted or acknowledged. China and many other emerging market countries do not know a rule of law in the way it defined the development of the West since the times of the Magna Carta. But, upon a closer look, subtle but substantial changes have taken place in the old world, too. Take the USA: Less and less people really believe that the rule of law and due process are still the defining concept of the USA when it handles legal cases against global companies. Many people reckon now that the USA uses, or abuses, the might of its legal systems to impose its will on the rest of the world. The Economist recently has called the US justice system an extortion racket.<sup>9</sup> But is Europe any better? The EU behaves like a government but often does not adhere to such basic governance principle as separation of power or due process. In antitrust cases, e.g., the Commission is rule maker, regulator, prosecutor, and judge all in one.

In a similar vein, prosecutors and regulators around the globe are now much more powerful than they were a few decades ago. In the first phases of globalization, national authorities and governments had difficulties to get their arms around the corporate colossus which so easily wandered from one jurisdiction to the other and could arbitrage amongst them. The many crises and scandals with which global business was embroiled and an increasing negative public sentiment against big business has strengthened the backs of national governments and their enforcement arms. Also, regulators and prosecutors now cooperate much better amongst themselves around the globe. And they have learnt to apply ways and means which go considerably beyond the standards of traditional investigation and prosecution. They use the public forum rather than the tradi-

---

<sup>8</sup> See Ulrich Beck, *Risikogesellschaft*, 21st edn (Frankfurt am Main: Suhrkamp, 2012, originally published in 1986).

<sup>9</sup> The Economist, 5 July and 30 August 2014.

tional courts to indict and blame companies; they bully them into settlements and deferred prosecution agreements rather than to seek a fair trial; and they reach across their geographic boundaries and no longer limit their activities to their own jurisdiction.

### III. FROM BUREAUCRAZY TO STRATEGY

Global businesses face a huge challenge to manage and control legal risks but have not yet learnt how to react to it. The traditional approach to controlling these risks was to leave the management of legal issues to lawyers. Lawyers are an able and well-trained profession. They are specialists in knowing the rules and laws. They can draft legal documents and contracts which reduce and hedge legal risk in advance. When the risks materialize, they will represent the company in a court and before agencies to mitigate the fallout of the risks. But lawyers also have a number of shortcomings. They are normally not strategic thinkers (beyond the strategy in a particular case) and mostly limit their activities to a specific case or transaction. They do not analyze and assess risks in a long-term view and with the purpose to reduce these risks sustainably. Also, they are rarely trained in managing holistic processes which are needed to bring a huge organization in compliance with the million of rules which apply to it around the globe.

Since about 25 years, there is a growing belief within global companies that traditional lawyering is not sufficient to cope with the big challenge of being a good corporate citizen in a global world. As a consequence, companies rely more and more on a second sort of experts to manage the legal risks, speak the compliance managers or officers. These compliance officers have a mission to manage and control these legal risks in a very different way than the lawyers do. Lawyers advise on applicable rules, represent clients, write contracts, and manage legal cases. By contrast, compliance officers watch over – and control – adherence to legal, regulatory, and ethical rules. They run processes and technologies which are designed to improve the compliant behavior of an organization.

The activities of lawyers and compliance officers will often overlap or operate alongside each other, but in many ways they are also different: First, in one way compliance risks are more narrow than legal risks because legal risks dwell in an unlimited space (i.e., may emanate from any legal or contractual rule), while compliance risks mean a limited universe of clearly defined risks such as, for example, specific regulations for the financial industry or pharmaceutical companies, or specific laws such as antitrust laws or anti-bribery laws. Second, and reversely, compliance risks go beyond legal risks in the sense that they might involve the breach of rules which are not strictly speaking ‘legal’ – such as codes of conduct, ethical requirements, or even certain contractual obligations. Finally, compliance officers often are lawyers by training, too. But frequently, and increasingly so, they have a different background such as management, operational risk, finance, technology, or forensic analytics.

Most global companies take legal and compliance risk very serious. As a consequence, most of them have built huge legal departments and employ an armada of outside coun-

sel. Moreover, they run big compliance programs and have established substantial compliance departments. First the general counsels and now increasingly also the chief compliance officers have reached the level of the most senior officers within their companies with direct access to both CEO and the board of directors. As if this were not yet sufficient, a row of other experts and advisors join the ranks of those who manage and control legal and compliance risks: internal controllers add legal issues to their control activities, internal auditors check on adherence to legal requirements, HR experts specialize in compliance training, and communication specialists learn to make compliance values known to the staff. And we see in many companies a growing number of operational risk managers identifying and assessing legal risks, ethic managers overseeing the code of conducts and other ethical matters, and legal project managers who manage large legal cases without being lawyers.

There are now so many processes, operations, techniques, specialists, experts, and advisors in the space of legal and compliance matters that many companies perceive a need of an additional process, speak the convergence or integration process. This is certainly necessary but at the same time the whole convergence discussion shows without mercy that the traditional approach of managing legal risk has come to its limits. In essence, the traditional approach consists in adding ever more and different specialists to legal and compliance activities and in piling one process on the other. This creates huge bureaucracies, makes all these busy experts and advisors happy, and soothes the many worries of the senior managers. But is this really in the best interest of global business? Is it up to the challenge of a rising tide of legal and compliance risk? I do not think so. I rather reckon that it is time to take a very different approach which I call the strategic management of legal and compliance risk.

#### IV. A ROADMAP TO LEGAL RISK MANAGEMENT

The strategic approach to the management of legal and compliance risks rests on three pillars:

The first one is the notion that managing these risks must not be left to the experts but rather should be steered from the very top of an organization, the senior management and the board. Business people are often more than happy to leave risk matters to the experts; they prefer to work on the opportunity side of the business. Discussing a new company logo, conquering a new country, building an additional plant appeal more to board members than awkward and embarrassing risk issues. A strategic approach to legal and compliance risk management will start with breaking this behavioral bias of leaving risk issues to experts and advisors.

The second notion is that companies should define the legal and compliance risk management as a core management process which engages all elements of the company, pretty much like a business planning, strategy, or product development process does. A company might push this process even to an extent where it gets a distinctive capability

of it and sets it apart from its competitors.

The third notion is that companies should, as they do in other fields, use specific tools to develop and support the process of legal and compliance risk management. In my book, I have presented a number of such tools which interrelate with each other. The top tool is a simple model which I called the Roadmap to Legal Risk Management.<sup>10</sup> The key idea behind the Roadmap is that the company, and this means its strategic and highest governance bodies, should go through a process which consists of seven steps: (1) understanding the roots, (2) defining a strategy, (3) setting the risk governance, (4) implementing processes and operations, (4) sourcing experts and advisors, (5) using technology, (7) influencing behavior of staff.

I have talked above a bit about the first of these seven elements, i.e. the root causes, but with the Roadmap I suggested that this discussion should go beyond these general observations and address the specific internal and external risk drivers of a company. I will in the following talk on the challenge of setting a strategy and I will add a few remarks on the rising importance of technology and nudging people into proper behavior. I will leave apart here the three other elements of the Roadmap since risk governance, operations, and processes, as well as sourcing experts and advisors, follow the more traditional lines of managing these risks and will be known and understood by the readers of this special interest publication.

## V. DEFINING THE STRATEGY

Each company should have a defined strategy of how it copes with the rising legal and compliance risks. Setting this strategy is a task for the highest bodies within a company – that is the board and the chief executive. It must not be left to lower echelons, even not the general counsel or the chief compliance officer who should act as the main advisors, experts, and managers but who should not be the end of the road and the final authority in these matters. There is a very simple reason behind this: a board or a chief executive who identifies the main legal risks facing the company in a clear and unambiguous way can do more for reducing these risks than a whole armada of lawyers or compliance officers. It can decide:

- not to go into a jurisdiction which is rife with corruption;
- to withdraw a product which is prone to fail;
- to stop a business activity where people must cut corners to be successful;
- to create a culture which helps to be compliant; and
- to build an open information space where misdeeds or impending misdeeds are quickly identified and corrected.

---

<sup>10</sup> Peter Kurer, *Legal and Compliance Risk* (Oxford: Oxford University Press, 2015), pp 9f.

To add colors to this: we all know that certain countries are more corrupt than others and we have quite reliable data on them by the work of Transparency International and others. Nonetheless, global companies often are active in these countries without compelling need. Here, it might sometimes be helpful to withdraw from one or the other of these countries and forego a (mostly tiny) part of the profits for the benefit of considerable risk reduction. Very similar considerations apply to the product or operational areas. I will come back to culture and values but we can say that creating an appropriate legal and compliance culture is now a key element of what the strategic level of a company should work on.

A board and a chief executive officer should go through a very systematic process for defining and redefining the strategy of legal and compliance risk management. It should make the risks visible, understand the drivers behind them, assess them in terms of monetary value, and make the necessary decisions as outlined above. Then, in a second step, it should clearly communicate its decisions and targets and make appropriate arrangements for risk mitigation. Finally it should control them and establish appropriate and efficient feedback and reporting systems.

## VI. CUTTING EDGE: TECHNOLOGY AND NUDGING BEHAVIOUR

Many managers but also experts like lawyers or compliance officers share two common traits: they have a very high belief and trust in their own activities and do not see that increasingly they can be replaced by technology. And they are very cerebral and believe that a problem is solved when it is intellectually understood and addressed; in this way they think that something is under control when a proper policy is written, a code of conduct is sufficiently communicated, or training has been made and certified; they naively believe that the behavior of their staff follows their rational thinking. These two traits are a fallacy and a trap and often stand in the way of efficient and effective risk management. Rather, whoever wants to be cutting edge in legal and compliance risk control should think long and hard on technology and people behavior; they are the new frontier in this space.

We have all witnessed a significant technological development in our generation. Thirty years ago, cars were a matter of mechanical engineering, radio and television were the only electronic media, the ticker was the exclusive transmittal of instant written communication, and books were the main carrier of data for lawyers. These times are gone. Cars are now more about electronics than engineering, present-day communication goes now through many different channels beyond the traditional ones, like the internet, social media, or Skype. In the same way, technology is becoming ever more important in

legal, compliance, and risk management activities.<sup>11</sup> Most legal and compliance departments will now use technology in areas such as information gathering and analytics; document and data handling, including automatic production of complex legal documents; operational management systems; mobile computing and communication; e-learning and e-training; as well as reporting.

But all this is not the end of it. We are in the middle of another technological revolution. Big Data, Artificial Intelligence, the Cloud, and Fintech will make great contributions to how legal and compliance issues will be managed in the future. Embracing these technologies will reduce costs and increase both efficiency and impact of risk management efforts. Despite all this, in the real life lawyers and legal risk managers do not yet use these technologies to their fullest extent. Traditional behavior and resistance to something that will ultimately make many professionals redundant stand as a roadblock to development.

After technology, influencing employee behavior is the second cutting edge technique in legal and compliance risk management. The banking crisis has made it apparent that employee conduct, or to put it more directly, misbehaving by employees, is a major source of legal risk and compliance breaches. Consequently, there is a lot of debate about establishing a proper company culture, setting the right tone at the top of the company, and managing staff conduct. There is, however, a very basic problem attached to this: we know a lot about the law, compliance requirements, management techniques, or even technology. By contrast, we know very little about human behavior. Fortunately, the events around the banking crisis has caused a lot of empirical research into these matters by noted behavioral economists and psychologists like Dan Ariely, Ernst Fehr, Daniel Kahneman, Richard Thaler, and others. These scientist do empirical research into such matters as how do people come to the right decisions, how can I design a solid decision architecture, under what conditions will people misbehave, or how can I mold staff into self-correcting improper behavior.

Some of this research has resulted in very concrete proposals for improving compliance management. Consulting company FehrAdvice has developed a compliance survey method which is much more reliable than the traditional methods.<sup>12</sup> Research done by Dan Ariely and others has made apparent that people will make more honest decisions when they have to sign a simple commitment like a professional oath or the ten commandments.<sup>13</sup> Any manager and legal risk expert who want to be serious about compli-

---

<sup>11</sup> See Richard Susskind, *Tomorrow's Lawyers* (Oxford: Oxford University Press, 2013).

<sup>12</sup> Peter Kurer, *Legal and Compliance Risk* (Oxford: Oxford University Press, 2015), pp 244-247.

<sup>13</sup> See Dan Ariely, *Predictably Irrational*, revised and expanded edn, international edn (New York: HarperCollins, 2010, originally published in 2008, in a different format, by HarperCollins), pp 282-91.

ance should be familiar with the principal results of these studies. And there is, indeed, an emerging generation of younger managers who follow these approaches. I know of one CEO who manages his company around seven well defined values, calls himself chief of culture, has given to every employee a luggage label which lists the seven values, and asks his employees to open every internal presentation on a very short note why she or he would like to talk on one of the seven values. This CEO never had any major compliance issue though he heads a major operation active in more than 60 countries.

## VII. CONCLUSION

As any glance on the daily headlines proves, global companies face increasing legal and compliance risks. Senior leaders now think that there is no other class of risks which exceeds the legal and compliance uncertainties. At the same time, however, these business leaders do not believe that they really understand these risks and how to handle them. They leave the management of them happily to experts like lawyers, compliance officers, risk managers, auditors, internal controllers, and others. And these experts happily take responsibility because they live on it. I have argued that this approach stands in the way of an efficient and effective management of the risks. We live in a world which is very different by now than what it was thirty years ago, prior to the great push of globalization. This new global world is full of legal threats, traps, and cracks, all creating present and imminent danger to the smooth operation of global companies. Therefore, what is needed is a much more strategic approach to these risk matters. Boards and CEO have to take control; they have to understand and perceive the nature of these risks and what is behind them; they have to give a strategic response on the level of business planning and new business approvals; and they have to create an open and honest culture around this.

It is not good for the global society when the biggest and most important companies of this world are seen as almost at war with governments. It is not good when public sentiment against big business becomes so negative that regulators and prosecutors are induced to intervene in the most drastic way, often much beyond what a sober and realistic assessment of a legal failure would really warrant. It is not good for society when the justice system is perceived as an extortion racket. And it is not good when the trust in the rule of law and due process is on decline. Business leaders, however, cannot do very much about excesses on the side of politics and policy makers. But they can do one thing: they can manage legal and compliance risks better than many of them do now. They can manage these risks smarter and with a much more strategic and cultural thrust. Business leaders who engage themselves in this way make a huge contribution to the legal culture in a global world which presently appears to be so void of it.