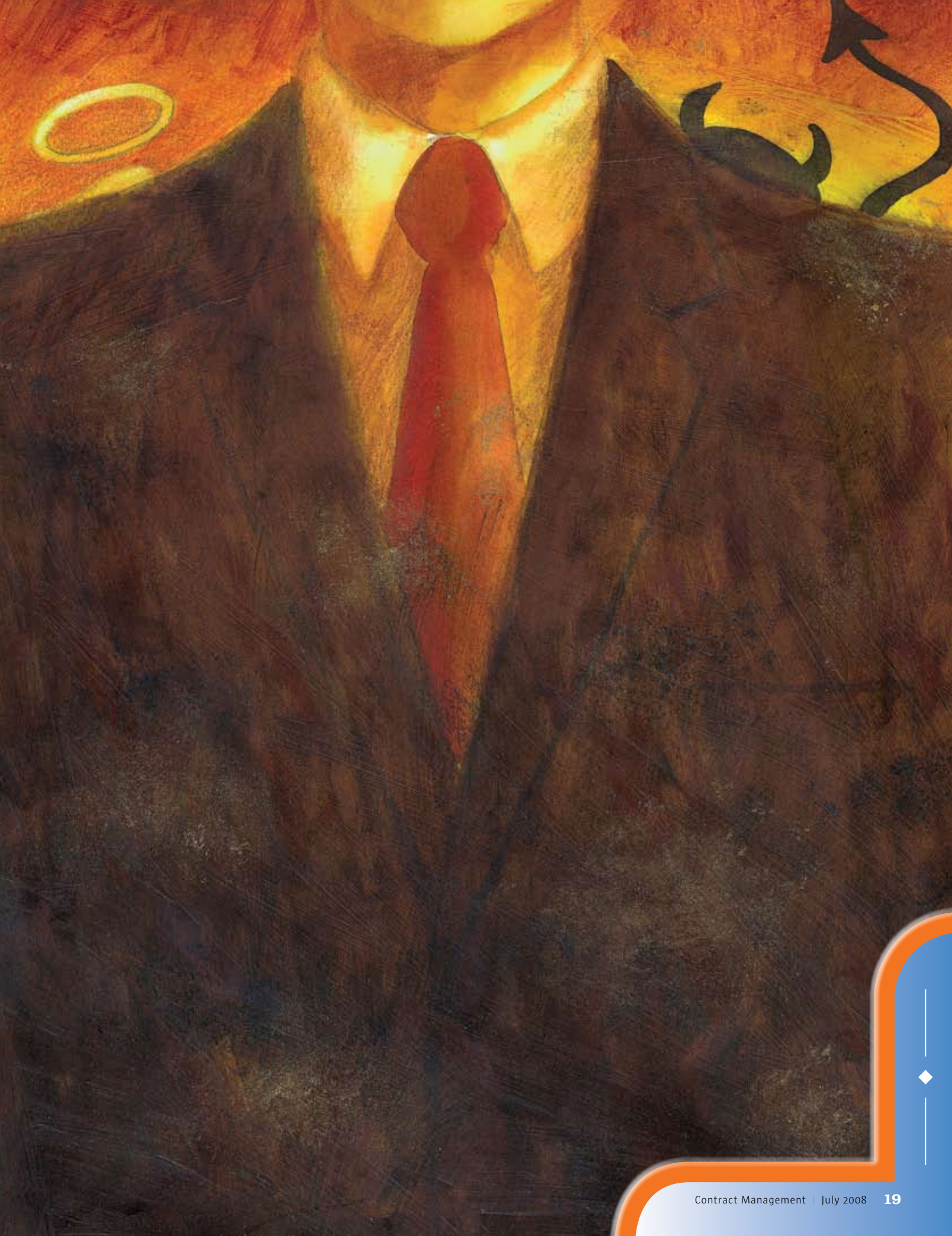


# The New *FAR* Codes of Conduct and Compliance Programs Provisions:

Are **You** Ethical Enough for Government Work?

*An explanation and analysis of the new ethics and compliance requirements recently added to FAR Part 3 (as well as the proposed revisions), what contracts trigger them, and which contractors are exempt.*

BY THOMAS A. MARCINKO



**7** *he late U.S. Supreme Court Justice Oliver Wendell Holmes famously opined, “Men must turn square corners when they deal with the government.”<sup>1</sup> Also, Benjamin Franklin once wrote, “There is no kind of dishonesty into which otherwise good people more easily fall, than that of defrauding the government.”<sup>2</sup> Together, these two observations describe a powerful dynamic that the government contracting community has been trying to address ever since the Revolutionary War.*

This year, the United States has entered into a new era in its efforts to overcome human nature and “square up” the corners of government contracting. Effective December 24, 2007, the *Federal Acquisition Regulation (FAR)* was modified to substantially increase the ethics and compliance requirements for government contractors.<sup>3</sup> The new regulations set forth the government’s policy in this regard and implement several mandatory requirements. However, some contractors and certain types of contracts are exempt from the mandatory requirements. Revisions to these recently enacted provisions—some controversial—have already been proposed. This article will explain, analyze, and comment on the new regulations, as well as the proposed revisions.

FAR Part 3, Improper Business Practices and Personal Conflicts of Interest, has been revised to include new Subpart 3.10, titled “Contractor Code of Business Ethics and Conduct.” This new subpart prescribes “policies and procedures for the establishment of contractor codes of business ethics and conduct, and display of agency [Office of the Inspector General (OIG)] fraud hotline posters.”<sup>4</sup> The new requirements apply to contracts awarded after the effective date but, as will be further discussed, may have some applicability to existing contracts.

## Policy

The policy is set forth in FAR 3.1002. Initially, the regulation states that “[c]ontractors must conduct themselves with the highest degree of integrity and honesty” and that “[c]ontractors should have a written code of

business ethics and conduct.” To promote compliance with their code, “[c]ontractors should have an employee ethics and compliance training program and an internal control system.” The training program and internal controls should be “suitable to the size of the company and the extent of its involvement in [g]overnment contracting.” At a minimum, the training program and internal control system must “facilitate timely discovery and disclosure of improper conduct” and “ensure corrective measures are promptly instituted.”

The FAR Council purposely chose the word “should” because the policy statement does not impose any mandatory requirements. Rather, it is considered guidance. The mandatory requirements are addressed in FAR 3.1003 and the applicable clauses. The reason for the distinction is that some contractors will be exempt from the mandatory requirements, but the policy applies to all contractors.

The use of the word “suitable” is also noteworthy. The provision states that the compliance program and internal controls should facilitate discovery, disclosure, and implementation of corrective actions. However, the policy statement offers no guidance as to how these objectives should be accomplished, or otherwise what would constitute an acceptable code of conduct, training program, or internal control system. The FAR Council received several recommendations that the government provide more detailed guidance as to exactly what is required in order to have an acceptable compliance program. The council explicitly rejected this approach. In their view, each

contractor needs to review its operations to determine the specific program that best fits its circumstances.<sup>5</sup> Among other advantages, this approach allows smaller contractors to have less extensive compliance programs.

It also should be noted that the policy “guidance” indicates that contractors should disclose improper conduct. Significantly, disclosure was not included as a mandatory requirement.

## Threshold for Application of Mandatory Requirements

FAR 3.1001 states that the “requirements set forth in the clauses at 52.203-13, Contractor Code of Business Ethics and Conduct, and 52.203-14, Display of Hotline Poster(s), are mandatory if the contracts meet the conditions specified in the clause prescriptions at FAR 3.1004.” The thresholds for applicability of these two clauses differ slightly. Neither clause is required for acquisition of commercial items under FAR Part 12, nor for contracts that will be performed entirely outside the United States.<sup>6</sup> The Code of Conduct clause is only to be used for contracts that are expected to exceed \$5 million in value and that have a performance period of 120 days or more. The Fraud Hotline Poster clause is required when the agency has a fraud hotline poster or if the contract is funded with disaster assistance funds, and exceeds \$5 million in value or such lesser thresholds as established by the agency. (Hereinafter, contracts that meet these criteria will be referred to as “covered contracts.”)

## Mandatory Requirements: Code of Business Ethics and Conduct

### All Contractors

The mandatory requirements in FAR 52.203-13 are divided into those that apply to all contractors and those that only apply to large businesses. Any contractor that receives a covered contract must comply with the requirements set forth in 52.203-13(b). Specifically, the contractor must, within 30 days after contract award,

- Have a written code of business ethics and conduct,
- Provide a copy of the code to each employee engaged in the performance of the contract, and
- Promote compliance with its code of business ethics and conduct.

### Large Businesses

The requirements that are only mandatory for large businesses are set forth in FAR 52.203-13(c). This provision specifically states that the requirements do not apply “if the [c]ontractor has represented itself as a small business concern pursuant to the award of this contract.” It is important to note that a business must be classified as a small business pursuant to the North American Industry Classification System (NAICS) code applicable to that specific solicitation in order to be exempt from these requirements. Thus, an emerging business may win some contracts where they are exempt from the requirements of this section and may win others where the same requirements are mandatory.

Per FAR 52.230(c), the large business contractor shall establish, within 90 days after contract award,

1. An ongoing business ethics and business conduct awareness program and
  2. An internal control system.
    - i. The [c]ontractor’s internal control system shall:
      - A. Facilitate timely discovery of improper conduct in connection with [g]overnment contracts; and
      - B. Ensure corrective measures are promptly instituted and carried out.
    - ii. For example, the [c]ontractor’s internal control system should provide for:
      - A. Periodic reviews of company business practices, procedures, policies, and internal controls for compliance with the

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[c]ontractor’s code of business ethics and conduct and the special requirements of [g]overnment contracting;

- B. An internal reporting mechanism, such as a hotline, by which employees may report suspected instances of improper conduct, and instructions that encourage employees to make such reports;
- C. Internal and/or external audits, as appropriate; and
- D. Disciplinary action for improper conduct.

However, the contracting officer (CO) can allow a longer period than 30 or 90 days.<sup>7</sup> The regulations do not offer guidance as to when it would be appropriate for the CO to grant more time, nor does the clause limit the amount of additional time that can be granted.

As was the case in the FAR 3.10 policy statement, the term “code of business ethics and conduct” is not defined. Similarly, no guidance is provided as to what constitutes an acceptable awareness or compliance promotion program. Though the clause does set forth some objectives of an internal control system, it does not prescribe any specific approach. Conspicuous by its absence is any requirement to disclose improper conduct.

Though some of the terminology is taken from the U.S. Sentencing Guidelines, the lack of precise definitions is exacerbated because the policy statement and clause requirements use different terms to describe what appear to be similar, if not the same, functions. Per the policy, all contractors of whatever ilk should have an ethics and compliance training program. Additionally,

any contractor, large or small, that wins a covered contract must promote compliance with its code of conduct. Large contractors that win a covered contract must further establish an ongoing business ethics and conduct awareness program. As these phrases are undefined, it is impossible to determine, with any level of confidence, how a training program differs from a promotional program or from an awareness program.

However, as the FAR Council purposely uses different terminology applicable under different circumstances, the phrases must be describing different programs. All different businesses that win a covered

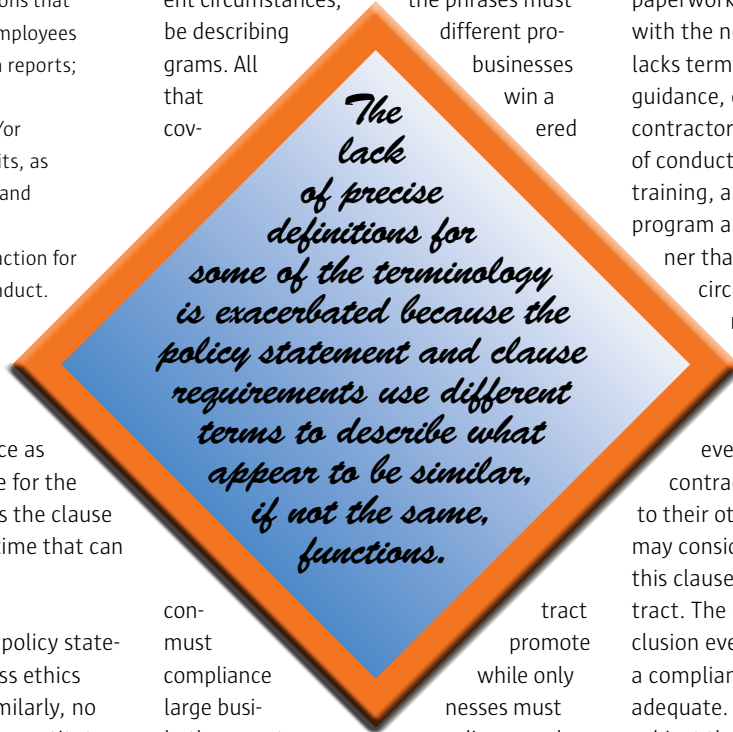
contract must promote compliance while only large businesses must both promote compliance and establish an awareness program. Therefore, it can be deduced that an awareness program is more extensive than promotion activities. Despite the fact that training is only mentioned in the non-mandatory policy section, it would be foolhardy for any contractor to assume that an acceptable promotion or awareness program could lack training.

Significantly, the government is not required to review and approve the code, the training program, the promotional activities, or the awareness program. Though not specified in the clause, the FAR Council stated that the CO is only required to verify that internal controls exist. However, it is not clear how this verification is to be

accomplished. Of course, the larger defense contractors may be subject to Defense Contract Audit Agency review of their internal controls. The FAR Council states that the CO may request information pertaining to the compliance program as part of routine contracts administration, but is not required to do so. Compliance with these requirements would most likely be reviewed in the event an ethics violation has occurred.<sup>8</sup>

Presumably, this *laissez faire* approach has been adopted, in part, to minimize the paperwork and bureaucracy associated with the new requirements. As the clause lacks terminology definitions, acceptability guidance, or approval requirements, the contractor has wide leeway to draft a code of conduct, promote compliance, provide training, and establish an awareness program and internal controls in any manner that seems appropriate under the circumstances. In fact, if there are no ethical issues, the government may never know whether a contractor complied with this clause. On the other hand, in the event an ethics violation occurs, the contractor may discover that in addition to their other problems, the government may consider them to be noncompliant with this clause and, thus, in default of their contract. The government could reach this conclusion even if the contractor implemented a compliance program that it believed was adequate. Such a finding would not only subject the contractor to the possibility of a default termination, but would also presumably result in harsher treatment from the justice system, not the leniency typically granted to companies with strong compliance programs. Therefore, contractors should take the requirements of the clause seriously, even though it does not require government approval.

There is another subtle difference between the mandatory requirements applicable to all contractors and those applicable only to large businesses. For all contractors, only employees “engaged in the performance of the contract” need to be provided with copies of the contractor’s code of business ethics and conduct.<sup>9</sup> Even if the phrase “engaged in the



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performance of the contract” is interpreted to include such typically indirect functions as billing or contract administration, employees assigned to other contracts are clearly excluded. In other words, codes of conduct and promoting compliance are contractwide, not companywide requirements. It may not be a good idea, but the clause sanctions an approach where only employees working on covered contracts receive codes of conduct and compliance promotion.

Furthermore, a contractor could develop distinct codes of business ethics and conduct and promote them differently on a contract-by-contract basis. This contract-specific approach might be warranted, if not required, in the event a company wins a contract that differs from its main business and has unique compliance risks not adequately addressed in an overall compliance program.

On the other hand, one of the internal control objectives applicable to large businesses is to facilitate timely discovery of improper conduct in connection with “government contracts.”<sup>10</sup> This terminology indicates that

if one covered contract is won by a large business, all of that business’s government contracts must be covered by the internal control system. This introduces an element of retroactive application to the new regulations.

The mandatory requirements of this clause merit two final comments. The internal control system must provide a mechanism, such as a hotline, by which employees may report improper conduct. Surprisingly, there is no requirement that the employee be given the ability to anonymously report improper conduct. However, any contractor that fails to provide the ability for employees to anonymously report misconduct is doing so at its own risk.

Also, the word “improper” is used in both the policy statement and the aforementioned internal control requirement. In this context, though not defined in the clause, “improper” can be defined as “not in accordance with the accepted standards of something such as a profession.” Thus, the word “improper” covers a wide variety of conduct, not just criminal behavior.

However, proper behavior in one setting may be improper in another. Therefore, it is imperative that each contractor understand what constitutes improper behavior in its profession.

### Subcontractors

The clause is required to be included in all subcontracts that meet the requirements for prime contract applicability (i.e., over \$5 million, over 120 days, etc.).<sup>11</sup> Some comments were received that prime contractors, especially small business primes, could not effectively enforce such provisions with their large business subcontractors. In response, the FAR Council stated that the prime contractor does not need to determine the acceptability of the subcontractor’s compliance program, just to ensure that it exists.<sup>12</sup>

It is interesting to note that this is a more stringent requirement than what is imposed on the CO. According to the FAR Council, the CO isn’t even required to ensure that the prime contractor has a compliance program

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at all. Presumably, prime contractors will have to develop a procedure that requires a covered subcontractor to certify that it is in compliance with the clause.

### Mandatory Requirements: Display of Hotline Posters

The mandatory requirements set forth in FAR 52.203-14 are, thankfully, much simpler to understand. All contractors shall prominently display the pertinent agency or Department of Homeland Security (DHS) fraud hotline poster. The specific posters to be displayed will be identified by the CO in the clause. The posters are to be displayed at business segments performing work under the contract or at work sites. To the extent a contractor maintains a Web site as a method of providing information to employees, the contractor shall display an electronic version of the poster(s) on the Web site.<sup>13</sup>

There is a caveat, however. The contractor does not have to display the agency poster if the contractor has a business ethics and conduct program that includes a reporting mechanism such as a hotline poster. However, the DHS poster, if required, would still have to be displayed. As previously noted, there is no requirement for a reporting mechanism to allow for anonymous reporting. Additionally, this clause also must be included in any covered subcontracts. This ability to use your own hotline poster in lieu of the agency’s poster is important because it will almost always be in the contractor’s best interest to have employees report misconduct to the company rather than directly to the government.

### Proposed Regulations

Some of the more controversial items are included in the proposed revisions that are currently out for public comment (e.g., FAR Case 2007-006).<sup>14</sup> The proposed revisions add a requirement for disclosure and provide more specific compliance program and internal control requirements. The proposed revisions are more specifically described in the following section.

### Policy

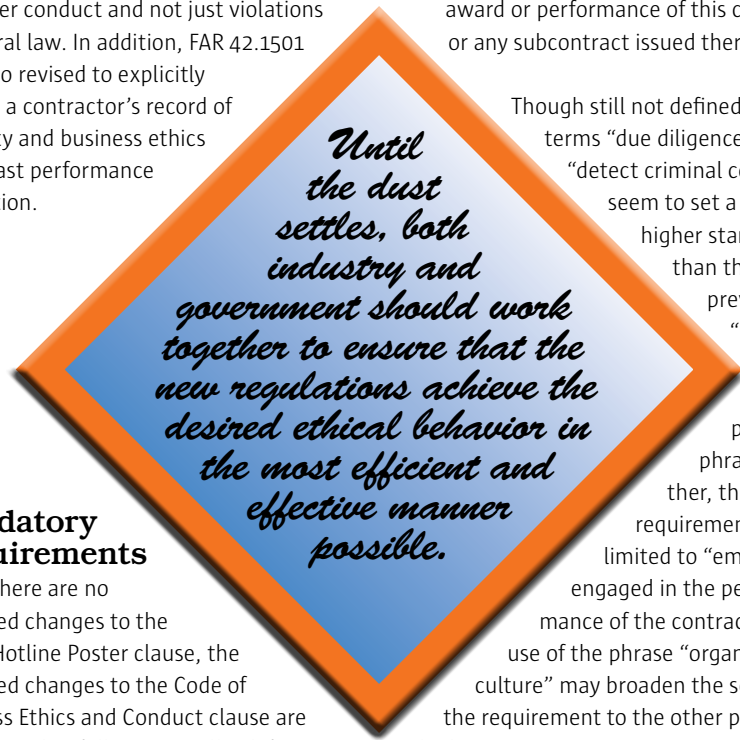
The proposed revisions would add provisions to FAR 3.1002, 9.406, and 9.407 to make knowing failure to timely disclose a violation of federal criminal law, in connection with the award or performance of any government contract performed by the contractor or a subcontract awarded thereunder, a cause for debarment or suspension. However, it is not clear whether the timely disclosure requirement means that the violation would have to be disclosed as soon as it was discovered or if disclosure can wait until the contractor has completed its own investigation. Also, the policy subjects the prime contractor to possible debarment or suspension for failure to disclose violations committed by its subcontractors.

Note the use of the words “federal” and “criminal.” Failure to disclose improper conduct that does not violate federal law will not be grounds for debarment or suspension. This is true even if the improper conduct violates state or international laws. This is more limited than the current policy that seeks, but does not require, disclosure of all improper conduct and not just violations of federal law. In addition, FAR 42.1501 was also revised to explicitly include a contractor’s record of integrity and business ethics in its past performance evaluation.

the company’s behalf or that have primary management or supervisory responsibilities within a business entity. Principals also figure prominently in one of the proposed revisions to the mandatory requirements.

As explained previously, FAR 52.203-13(b) currently requires all contractors who receive a covered contract to “promote compliance with its code of business ethics and conduct.” FAR Case 2007-006 would change this provision to read that the contractor shall:

- Exercise due diligence to prevent and detect criminal conduct,
- Promote an organizational culture that encourages ethical conduct and a commitment to compliance with the law, and
- Notify in writing the agency OIG and the CO whenever the contractor has reasonable grounds to believe that the contractor has committed a violation of federal law in connection with the award or performance of this contract or any subcontract issued thereunder.



Though still not defined, the terms “due diligence” and “detect criminal conduct” seem to set a much higher standard than the previous “promote compliance” phrase. Further, though the requirement is still limited to “employees engaged in the performance of the contract,” the use of the phrase “organizational culture” may broaden the scope of the requirement to the other parts of the business entity.

### Mandatory Requirements

While there are no proposed changes to the Fraud Hotline Poster clause, the proposed changes to the Code of Business Ethics and Conduct clause are summarized as follows. Initially, definitions were added to FAR 52.230-13(a) for the terms “agents” and “principals.” Basically, these are individuals authorized to act on

Lastly, disclosure is required once there are “reasonable grounds” to believe the

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contractor has committed a violation. This disclosure requirement raises two points. First, it is not clear what level of management must be aware of the potential violation before disclosure is required. Secondly, the “reasonable grounds” terminology appears to establish a “reasonable and ordinarily prudent” standard. Even if the contractor’s management failed, for whatever reason, to accurately assess the situation as long as a reasonable and ordinarily prudent businessman would have, then reasonable grounds exist and the requirement to disclose has been triggered. This interpretation precludes a contractor’s management from adopting an “ostrich” or “head-in-the-sand” approach to avoid the disclosure requirement.

Significantly, these requirements, if promulgated, are in the portion of the clause that applies to both large and small businesses. FAR 52.203(c), which only applies to large businesses, currently requires an “ongoing business ethics and business conduct awareness program” and “an internal control system.” As previously discussed, the clause offers no guidance pertaining to the ongoing awareness program but does provide some attributes that an internal control system must have. The proposed revisions would provide guidance as to what constitutes an acceptable awareness program, as well as more detailed internal control requirements.

According to the proposed revisions, “an awareness program should periodically communicate the [c]ontractor’s standards, procedures, and other aspects of business ethics, compliance, and internal controls through effective training and other means of disseminating information appropriate to an individual’s responsibilities.” The revised regulation goes on to state that “training shall be provided to the [c]ontractor’s principals and employees, and when appropriate, to agents and subcontractors.” However, the proposed provision does not address when it would be appropriate to train agents or subcontractors, or even what constitutes effective training. Presumably, large business subcontractors with their own training programs would not need to be trained by their primes. Also, the use of the word “effective” may imply that some type

of metrics must be developed to measure the effectiveness of the training. Or could effectiveness be measured by effort, not results?

The proposed revisions also add several new internal control requirements. These revisions are listed as follows with comments where appropriate.

At a minimum, the internal control system shall provide for:

1. Assignment of responsibility at a sufficiently high level and adequate resources to ensure the effectiveness of the compliance program.

How high in the organization and how many resources are considered to be adequate are left to the discretion of the contractor, but the word “ensure” is definitely a strong word.

2. Reasonable efforts not to hire or assign principals whom due diligence would have exposed as having engaged in conduct that is illegal or otherwise in conflict with the [c]ontractor’s code of business ethics and conduct.

Initially, each contractor will have to determine which employees qualify as principals based on the new definition. Oddly, the contractor is not required to exercise the same due diligence when hiring agents. It is not clear how much “due diligence” is reasonable. At a minimum, it appears criminal background checks would be required, but such checks would not necessarily disclose all objectionable conduct. Further, the use of the word “engaged,” without caveat or limitation, seems to exclude any possibility that an individual could have rehabilitated themselves. Lastly, it is not clear if this provision requires a contractor to remove an employee if improper past conduct is discovered after employment, even if the employee has been doing a good job.

3. Monitoring and auditing to detect criminal conduct;

4. Periodic assessments of the risk of criminal conduct with modifications to the compliance program and internal controls as warranted to reduce the risk;
5. The ability for employees to report suspected improper conduct anonymously or confidentially.

Large businesses winning a covered contract would have to allow for anonymous or confidential reporting of improper conduct. However, confidential is not the same as anonymous. Presumably, the requirement for full cooperation set forth in the upcoming item 7 would not require the contractor to disclose the name of a whistleblower who had been promised confidentiality.

6. Disciplinary action for failing to take reasonable steps to detect or prevent improper conduct.

Employees who were uninvolved and unaware of the improper conduct will be subject to discipline if, as part of their compliance duties, they could have prevented or detected it. Therefore, it will be imperative that every employee understand and perform their roles and responsibilities in regard to preventing or detecting improper conduct.

7. Full cooperation with any [g]overnment agency responsible for audit, investigation, or corrective actions.

It is not clear how defending oneself, taking advantage of legal rights, etc., fits into the definition of full cooperation. It is also not clear what happens when the contractor’s contractual obligations and an employee’s constitutional rights conflict. It should also be noted that full cooperation will apply to government audits or investigations of any kind. Further, the disclosure requirements previously set forth in section (b) are restated as a mandatory component of the section (c) internal control system.

These proposed requirements, combined with the requirements already included in

the existing clause, describe a robust and expensive internal control system. Please note that a small business only has to win one covered contract where they don't qualify as "small" under the NAICS code. And they have only 90 days to implement such a system!

## Conclusion

The ethical requirements for contracting with the federal government are entering a new, more stringent era. Many aspects of compliance that were formerly voluntary are now required, and more changes are likely.

While Justice Holmes would feel vindicated, Benjamin Franklin would most likely still be skeptical. The new compliance provisions, both current and proposed, are sufficiently vague as to be dangerous. It will therefore take some time for both industry and government to fully appreciate how they will work in practice. Some contractors may expend resources unnecessarily. Others may not do enough. It is very possible that innocent

parties will be hurt in the process. Caution and concern are appropriate reactions.

Until the dust settles, both industry and government should work together to ensure that the new regulations achieve the desired ethical behavior in the most efficient and effective manner possible. If government and industry both adopt this objective, the renewed emphasis on ethics will achieve more than compliant behavior; it will result in more successful government contracts and more successful government contractors. **CM**

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### ABOUT THE AUTHOR

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### ENDNOTES

1. *Rock Island, Arkansas & Louisiana Railroad Company v. United States*, 254 U.S. 141, 143 (1920).
2. Keeney, Sandy, "The Foundations of Government Contracting," *Journal of Contract Management*, Summer 2007, Volume 5.
3. 225 *Federal Register* 65878, November 23, 2007.
4. FAR Part 3.1000.
5. *Federal Register*, op. cit.
6. As of this writing, it appears the exemption for contracts performed overseas will be rescinded.
7. FAR 52.203-13(b) and (c).
8. *Federal Register*, see note 3.
9. FAR 52.203-13(b)(ii).
10. FAR 52.203-13(c)(2)(i)(A).
11. FAR 52.203-13(d).
12. 225 *Federal Register* 65880, November 23, 2007.
13. FAR 52.203-14(b)(1) and (2).
14. 219 *Federal Register* 64019-64023, November 14, 2007.

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