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SEC GIVES DETAILS ABOUT WHEN COOPERATION WILL COUNT

Once corporate leaders become aware of possible internal wrongdoing, their actions can significantly impact how the federal government will react months and years down the road. On October 23, 2001, the SEC described factors it will consider when evaluating the degree to which a company's actions after discovering possible problems, including its efforts to cooperate with the SEC, will prompt the Commission to exercise prosecutorial discretion. The Report straightforwardly communicates the SEC's desire for corporate America to more aggressively uncover and deal with possible securities law violations, and its intent to credit those efforts when deciding how the SEC should address the underlying conduct. *See*

<http://www.sec.gov/litigation/investreport/34-44969.htm>.

The Report. The SEC's Report focuses on a particular, unnamed parent company whose cooperation inspired the SEC not to institute any enforcement action against the company itself. On the same day, however, the SEC commenced and settled an administrative proceeding against the controller of that company's subsidiary, charging that the controller booked improper entries overstating deferred cost assets and understating expenses from 1995 through 2000. The SEC alleges that, by December 1998, she knew that these entries were improper, but instead of raising the issue with her superiors, she deliberately concealed the incorrect entries. The SEC found that the controller's conduct caused misstatements in the company's annual and

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quarterly reports and caused inaccuracies in the company's books and records. *See* <http://www.sec.gov/litigation/admin/34-44970.htm>

The SEC noted that, within a week after discovering that there apparently had been misconduct, the company had involved its internal auditors, senior management and the audit committee in a preliminary review. Four days after the full Board was advised and authorized the company to hire outside counsel to conduct a thorough inquiry, the company dismissed the controller and two of her supervisors. A day after that, the company announced, both publicly and to the SEC, that its financial statements would be restated. The company also provided the Staff of the SEC's Enforcement Division with all information it uncovered regarding the underlying violations and did not invoke the attorney-client privilege or work product protection. Finally, the company strengthened its financial reporting processes and hired three new CPAs for the accounting department responsible for preparing the subsidiary's financial statements.

The SEC used the facts of this case as a backdrop for announcing four categories of detailed criteria it will use in future enforcement contexts to evaluate a company's cooperation:

1. *Self-policing* - whether the company established, maintained and enforced effective compliance procedures.
2. *Self-reporting* - whether the company promptly, thoroughly and effectively investigated the nature and extent of the misconduct and reported the misconduct to the appropriate regulators, as well as to the public.
3. *Remediation* - whether the company properly disciplined the wrongdoers, strengthened internal controls and procedures to prevent recurrence, and, if appropriate, compensated those adversely affected.
4. *Cooperation* - whether the company provided the SEC with all available information relevant to the underlying misconduct.

The SEC was careful to highlight investor protection as its primary concern, noting that this list may not be strictly applied in every case. Indeed, under some circumstances, no amount of cooperation will convince the SEC not to bring an enforcement action. While reserving complete prosecutorial discretion, the SEC's description of potentially relevant factors offers opportunities for companies to position themselves well, in case SEC scrutiny does occur.

Practice Points. The Report lists many questions the Commission may ask when evaluating whether "credit" should be given in light of a company's cooperation. To position themselves to be able to qualify for this "credit" where appropriate, public companies and regulated entities should consider and, perhaps, re-evaluate the following items:

1. **Review the adequacy of your existing compliance regime.** The SEC's Report illustrates that having an effective compliance program has never been more important. An effective program creates a vehicle to identify and address potential violations long before they generate government inquiries or lengthy litigation.

Determining the adequacy of a compliance regime, however, is not simply a paper project; it requires a deep evaluation of the effectiveness of compliance efforts. The Department of Justice, citing the federal sentencing guidelines for organizations, has articulated standards by which effectiveness should be measured, and any government authority is likely to use the same yardsticks:

- o a written program that establishes procedures reasonably designed to reduce the prospect of improper conduct;
- o communication of compliance standards to all relevant personnel;
- o training efforts that assure that compliance standards are understood;
- o monitoring and auditing efforts to detect violations of the policy;
- o mechanisms for reporting potential violations;

- consistent enforcement of the policy; and
 - an organizational structure that reflects the commitment of senior management and the board of directors to compliance efforts.
2. **Re-evaluate sources of risk and resources.** Consistent with our recent commentary on compliance with the Foreign Corrupt Practices Act, *see* <http://www.ffhsj.com/secreg/archives/sc010926.htm>, compliance efforts should concentrate on addressing the areas in which a corporate violation of the law is likely to occur. As businesses - and the ways of doing business - continue to evolve, companies need to reassess periodically the nature of legal violations that can arise. This requires the involvement of senior management and legal staff. Similarly, companies should periodically re-evaluate whether adequate resources are committed to its supervision and compliance framework. Resources dedicated to compliance functions should be commensurate with the nature of the particular business and the associated risks.
3. **Have a crisis management plan.** Companies need to know what they will do if and when a problem arises. In its Report, the SEC highlighted that management and the audit committee took rapid and decisive action to address the misconduct that had been discovered. The speed and clarity of this response was key to the SEC's decision to withhold enforcement sanctions. Companies should be prepared to focus quickly and execute a strategy, once this has been determined. In the SEC's view, good corporate citizens will seek to set things right - disciplining misconduct, compensating those harmed, and self-reporting to authorities.
4. **Act with an eye towards "full cooperation" with government authorities.** While it may not be appropriate in every circumstance, every corporation should preserve the option to self-report and cooperate with the authorities, given the potential such a strategy has for avoiding or minimizing sanctions for the misconduct of its

personnel. The corporate response to indications of potential misconduct - what is said, what is done, what is written - should be undertaken while cognizant of the possibility that the company may want to bare all before government authorities - waiving privileges and otherwise providing all available information. This corporate response also may come to light under other circumstances. Attention to this possibility from the start may help avoid potential embarrassments if and when a company decides to adopt such a strategy.

5. **The SEC may be willing to limit the "costs" associated with potential waivers of the attorney-client privilege.** It is a stock mantra of SEC attorneys (and other government counsel) that "full cooperation" may mean waiver of applicable privileges. The SEC's Report repeats that point but, in a footnote, notes that the Commission has argued recently, in an amicus brief, that release to SEC staff should be considered a limited waiver that should not waive the privilege with respect to third parties. While such support may not determine the outcome of such waivers, it signals a heightened sensitivity at the SEC to the collateral effects of providing the level of cooperation anticipated by the SEC's Report. There may now be opportunities to limit the adverse effects of that cooperation.
6. **Some judgment calls will become more important.** The SEC's Report stressed the promptness with which the company acted and reported to the SEC. In the future, there will be pressure to match that level of dispatch. It will fall to counsel to exercise sufficient diligence and judgment to meet a high standard before making a disclosure to the SEC. As always, there will be some - *e.g.*, disgruntled employees trying to bolster wrongful termination claims - who will make unfounded accusations with less than pure motives. Just as it is critical to take corrective action with actual violations, it will fall to counsel to have the fortitude to resist attempts to "self-report" conduct that does not constitute a violation.

The costs - institutional and individual - of a bad judgment will be draconian.

7. **Respond consistently and effectively to indications of potential wrongdoing.** In particular, this requires not only sanctioning corporate personnel involved in policy violations, but also subsequent re-evaluations of existing policies to determine whether compliance systems require revision to prevent a recurrence. The Report encourages public companies to invest more in self-regulation, recognizing that companies are in the best position to protect investors by deterring misconduct and by addressing improper activities promptly when they are first discovered. After all, while having effective compliance programs may limit the damage resulting from misconduct, the best use of such programs is to prevent misconduct from occurring in the first place!

Carmen J. Lawrence, New York, NY
Karl A. Groskaufmanis, Washington, DC
Dixie L. Johnson
Matt T. Morley
Paul H. Pashkoff

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