

SEC Enforcement – What Chief Legal Officers of SEC Reporting Companies Should be Focused On

It could be a chief legal officer's worst nightmare come true: a whistle-blower presents credible evidence of financial fraud, a subpoena arrives from the SEC regarding an investigation no one at the company knew the SEC had undertaken, disappointed investors file a securities fraud suit, which triggers an SEC investigation, the company's main competitor settles SEC charges in respect of what the SEC terms is an "industry-wide" accounting problem.

The following memorandum highlights the issues that the CLO of a US reporting company should very quickly focus on by reason of the potential involvement of the SEC and other issues that could arise under US law.

Background

Various financial scandals have attracted responses by US regulators and/or US plaintiffs. And, although the bases of liability may essentially be the same, the rules of the enforcement game have changed. Regulators, armed with stricter penalties, and feeling the political pressure to be more activist, have responded with a far more active enforcement agenda. The SEC's Division of Enforcement, spurred on by competition with the Department of Justice and State attorneys general (most notably New York's) and deploying a far greater number of investigators thanks to increased funding, is seeking out a far greater number of individual targets as well as, in what the Director of Enforcement at the SEC has referred to as "sweeps," targeting companies as part of a review of an entire industry's practices, even though there is no "clear road map of wrongdoing." Recent examples include investigations of vendor allowances (following the Ahold investigation) and reserve practices in the oil and gas industry (following the Shell investigation).

Today's investigations may extend to companies' outside auditors or employees and to third parties that do business with a possible subject of investigation. In the Ahold case, the SEC is now turning its attention to vendors that allegedly facilitated the inflating of revenues by providing false invoices. Regulators have pursued financial service firms for aiding and abetting public companies' violations of the securities laws (targeting both an insurance company and various investment banks).

Clearly the context, as well as the facts themselves, for each case will be different. Conduct that gives rise to misleading financial statements or other financial reporting may be the result of deliberate fraud or honest mistake. Senior management may be involved or may be taken by complete surprise. The conduct may involve a core asset or a recently acquired business. The company may

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have a first-rate compliance program in place, supported by a commitment from the top down to honesty and integrity or senior management may have encouraged, or at least tolerated, lax compliance. The audit committee and internal audit may have been fully diligent in their oversight roles, or while well-meaning may have been ill-equipped to oversee the complexities of the company's operations. The auditors may have been misled, or may have contributed to the breakdown in internal control.

What are the immediate steps I need to take?

In the event that the SEC Staff ("Staff") initiates contact, it is by no means certain that the CLO will be the first person to know. The company may be the subject of a formal or informal investigation, or may be asked to provide information in respect of an investigation of another company in the same industry, the entire industry or an associated company such as a supplier or customer. The SEC is under no compulsion to inform the company, or its internal counsel, of the nature of an investigation or even to go through legal and/or public relations or government relations staff when making inquiries. The company may receive a subpoena or letter seeking documents, or an employee may receive a phone call from the SEC asking questions.

Regardless of where or under what circumstances contact is initiated, the legal department needs to be prepared to "own" the process of working with the SEC and the most important things to do at the outset are to listen and be prepared to cooperate. The better you understand the nature of the inquiry, the more effectively you can respond, and while there are risks inherent in cooperating with the SEC (see below), cooperation is the most effective way to bring the matter to an early and less painful conclusion.

Even though the SEC may choose not to answer, the CLO should attempt to determine the nature of the inquiry, particularly whether the investigation is formal or informal. The Staff is empowered to conduct informal investigations, but must seek approval from the Commission for a formal order before opening a formal investigation. The Staff does not need to show cause to conduct an investigation. In addition to the obvious difference in severity, formal investigations allow the SEC to issue subpoenas to produce documents and compel testimony. That said, it is not difficult for the Staff to get approval for formal investigations and stonewalling an informal investigation almost guarantees escalation.

The SEC is not required to identify a company as being a target of an investigation. As noted above, the company may be a direct target or it may be caught up in an industry "sweep." An investigation may simply mean that the Staff has identified one or more issues that warrant investigation; the investigation may or may not result in an enforcement action.

The CLO should form a response team. The team should include representatives of senior management, legal, accounting, internal audit and investor relations. The CLO should advise the audit committee, the company's regular outside securities counsel and its auditors and the company's disclosure committee. (The audit committee may consider retaining separate independent securities counsel to conduct an investigation (see below).) Note that under the SEC certification requirements

for the CEO and the CFO, those two officers will be required to certify that they have advised the auditors and the audit committee of any fraud that involves management or other employees with a role in internal control and all “significant deficiencies” and “material weaknesses” (as now defined in PCAOB Auditing Standard No. 2) in the design and operation of the internal control.

The company will need to consider notifying any employees that may become potential witnesses. The company cannot instruct an employee not to cooperate with a regulator – that could be tantamount to obstruction of justice.

All persons who are made aware of the investigation must be advised as to the company’s disclosure policy and, if a decision is made to postpone public disclosure, need to be advised of the need for confidentiality. The CLO should ensure that any person who is advised of the development should cease trading in the company’s securities.

What level of cooperation with the SEC will be expected of us?

In the past few years, SEC determinations of cooperation, or lack thereof, have had a significant impact on the decision whether or not to bring suit, levy fines and the size of the fines levied. In October 2001, the SEC issued a Section 21(a) report (Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934 and Commission Statement on the Relationship of Cooperation to Agency Enforcement Decisions) explaining why it elected not to sanction a public company (Seaboard Corporation) by reason of the fact that Seaboard had satisfied four criteria the SEC used to assess effective cooperation. Companies that “seek out” illegal conduct through an effective ethics and compliance program, “self report” when malfeasance is discovered, “rectify” the conduct without waiting for an SEC order and “otherwise cooperate” with the Staff, stand a chance of being credited with such behavior when the SEC decides whether and how to take enforcement action.

As the SEC said in the Lucent enforcement action in 2004, “[c]ompanies whose actions delay, hinder or undermine SEC investigations will not succeed. Stiff sanctions and exposure of their conduct will serve as a reminder to companies that only genuine cooperation serves the best interest of investors.”

While cooperation can lead to penalty-free resolution in respect of fraud charges levied against the highest levels of an organization (Homestore) and while there is no guarantee that cooperation will be rewarded, the message is clear:

- waiting for the SEC to force disclosure of accounting irregularities and making misleading statements to the press during an investigation in respect of the underlying focus of the investigation (Dynegy);
- failing to produce documents, including e-mails, in a timely manner, failing to request extensions from the Staff of deadlines that will be missed, failing to alert the Staff that responses would be incomplete, failing to adequately explain document production delays, failing to provide accurate

responses as to document availability and, in some cases intentionally withholding or destroying documents (Banc of America Securities);

- expanding employee indemnification (to persons not entitled thereto) after signing an agreement in principle with the SEC to settle (Lucent);
- purposefully discarding key documents and rigging key financial data, instructing employees to withhold or delay the provision of information, including sanitizing material of wrong-doing (Symbol Technologies); or
- simply delaying and then conducting a lax internal investigation (Gemstar)

all have the potential to result, and have in fact resulted, in significant penalties.

In short, regulators will aggressively pursue, and sanction, conduct that appears to obstruct an investigation. As has recently been demonstrated, not only is obstruction of justice easier to prosecute than underlying claims that may turn on complex accounting or other questions, but obstruction of justice charges can result in penalties even though the underlying conduct does not.

When should we contact the SEC if we discover the problem first?

Self-reporting is a key element of the SEC's view on cooperation, and is also a key element of the US Sentencing Guidelines, which provides for credit if cooperation is both timely and thorough. In its list of the criteria it said it would consider in determining whether, and how much, to credit self-policing, self-reporting, remediation and cooperation (in the Section 21(a) Report), the SEC cited the following: Did the company promptly, completely and effectively disclose the existence of the misconduct to the public, regulators and self-regulators (i.e., the relevant stock exchanges)?

What will the initial response be to the SEC?

Even if the independent counsel is not retained, the company's securities counsel will need to interface with the SEC. The request for documents will be broad and the deadline for response may be short. Early contact will be necessary, again to establish the bona fides of the cooperation effort, and to bring the response process under control. Both scope and timing can be the subject of discussions with the Staff.

The process of responding to the request for documents must begin immediately. Again from a cooperation standpoint, the search must be complete and be credible. If there will be a delay in producing documents or the production will be incomplete, the Staff must be alerted ahead of time.

What is the potential value of an investigation by independent counsel?

An investigation is one of the elements cited by the SEC as an indicator of cooperation, particularly when coupled with remedial measures. To be credible, the investigation should be conducted by independent counsel. The Staff may defer a decision on its investigation if the company

volunteers to conduct an internal investigation. The Staff will expect to receive the report of the investigation. In the Section 21(a) Report, the SEC cites the following as part of its assessment of cooperation (emphasis added):

- “Did the company commit to learn the truth, fully and expeditiously? Did it do a thorough review of the nature, extent, origins and consequences of the conduct and related behavior? Did management, the Board or committees consisting solely of outside directors oversee the review? Did company employees or outside persons perform the review? If outside persons, *had they done other work for the company? Where the review was conducted by outside counsel, had management previously engaged such counsel? Were scope limitations placed on the review? If so, what were they?*”
- “Did the company promptly make available to our staff the results of its review and provide sufficient documentation reflecting its response to the situation? Did the company identify possible violative conduct and evidence with sufficient precision to facilitate prompt enforcement actions against those who violated the law? Did the company produce a thorough and probing written report detailing the finding of its review? Did the company voluntarily disclose information our staff did not directly request and otherwise might not have uncovered? Did the company ask its employees to cooperate with our staff and make all reasonable efforts to secure such cooperation?”

What should we disclose and when?

The SEC generally does not disclose the existence of an investigation and, if asked, will refuse to confirm or deny that it is investigating a particular target. Obviously if the investigation results in an enforcement action, that action will become public in the form of a public release.

In terms of public disclosure, there is no specific requirement to disclose the existence of an SEC investigation. If the company chooses to make a public disclosure, the CLO should coordinate with the response team to ensure that the message is consistent and honest. The CLO also needs to be mindful of Regulation FD obligations.

If the company does not currently intend to disclose the investigation, denying the existence of an investigation can have serious consequences. Among other things, it in and of itself can give rise to a claim of misleading public disclosure and has the strong potential to be interpreted by the SEC as an “uncooperative” move. As explanations for fines for failing to cooperate, the SEC cited, in the Dynegy enforcement action, false statements by the company’s CFO regarding the underlying conduct that gave rise to improper accounting and misleading disclosure and, in the Lucent enforcement action, an interview given by the CEO and the general counsel in which they characterized fraudulent accounting as a “failure of communication.” The SEC, and the courts, in a variety of contexts have made clear that if a company chooses to speak (and in denying an investigation, like denying ongoing merger discussions, a company is speaking), it must do so fully and honestly. Note that for US securities law purposes, a “no comment” response” is the equivalent of silence.

Some companies disclose an SEC investigation in the early stages after initial contact from the Staff. More often, companies will wait until receipt of a “Wells” notice, which indicates that the Staff has decided to recommend to the SEC that the SEC authorize an enforcement action. Other factors to consider are the materiality of the investigation (e.g., where the company or a whistleblower reported the matter to the SEC in the first place and the underlying facts known to the company suggest that the scope of the fraud is material) and the likelihood of a restatement or enforcement action. A company should also consider, from the standpoint of materiality, the scope of its insurance coverage and whether it would be exposed to significant unreimbursable defense costs.

The company may form a different view on disclosure if it is about to file its annual report on Form 10-K and certainly should consider the implications of non-disclosure if it plans to access the capital markets or has a “live” shelf registration statement in place. In addition to the traditional rationale for disclosing an investigation (as material information), the new internal control rules require management, in the company’s annual report on Form 10-K, to state whether the company’s internal controls are effective and to discuss any material weakness in internal control. Allegations of fraud are likely to raise questions of effectiveness of internal control, requiring disclosure.

Finally, the CLO needs to be prepared for a leak. Rumors of an investigation may appear where, for example, the investigation is part of an industry “sweep” and one or more other targets disclose that they are targets, or third parties are interviewed by the SEC, the target becomes clear and there is a leak.

If, because of:

- concern over potential leaks and a determination that “no comment” will be unsatisfactory;
- concerns over materiality;
- a determination that regardless of the outcome of the investigation, a restatement will be necessary;
- rumors in the market; or
- an impending SEC filing

or, for any other reason, the company discloses the investigation, it would be well-advised to have a carefully scripted response to media, shareholder, rating agency, creditor and other stakeholder inquiries. The principal factor militating against disclosure is that the disclosure could be (or in hindsight turns out to be) inaccurate, where for example the company denies wrongdoing only to learn that there was a basis for the investigation, or the problems turn out to be much worse than as disclosed.

What happens if we need to restate our financial statements?

If in the course of its investigation the company concludes that financial statements need to be restated, a press release is likely the first item to be considered. The language may require careful balancing as the internal investigation may not be complete, and yet there will be pressure to get information to the market as quickly as possible.

What are the potential bases of liability that we face?

The SEC has a range of legal theories on which to base liability for a company and the individuals involved. With the exception of the certification requirements for CEOs and CFOs, and the strengthening of rules in respect of improper influence over auditors, the bases on which the SEC will bring enforcement actions have not changed in recent years. For the company, these include:

- Section 17(a) – anti-fraud provision in connection with the offer and sale of securities (liability based on material misstatements or omissions in offering documents);
- Section 10(b) and Rule 10b-5 – anti-fraud provision in connection with the purchase and sale of securities (liability based on material misstatements or omissions in SEC periodic reports, press releases, analyst calls, etc.);
- Section 13(a) and Rule 13a-1 – obligation to file periodic reports, which (as held under the case law) requires that such reports be “true and correct” and not contain false and misleading statements;
- Sections 13(b)(2)(A) – reporting companies must keep books, records and accounts that, in reasonable detail, accurately and fairly reflect their transactions and dispositions of assets;
- Sections 13(b)(2)(B) – reporting companies must maintain adequate systems of internal accounting controls;
- Rule 13b2-1 – prohibits falsifying accounting books and records;
- Rule 13b2-2 – prohibits conduct that constitutes unlawful influence over accountants; and
- Rule 12b-20 – in addition to containing the disclosures expressly required by SEC rules, periodic reports must contain such other information as is necessary to ensure that the statements made are not, under the circumstance, materially misleading.

Individuals can be found to have aided and abetted the company’s violations of the foregoing, and the CEO and CFO can also have liability for providing false certifications in the company’s Form 10-K.

Could we be the subject of both civil and criminal prosecution?

The SEC cannot itself pursue criminal actions, but it can (and does) refer matters to the US Department of Justice. In addition, although the initial contact may be with the SEC, these days instead of the SEC, in the words of its Director of Enforcement, having to “cajole” prosecutors to criminally prosecute securities fraud cases, there are other regulators that become involved on their own motion, including the Department of Justice, State attorneys general and regulators in other jurisdictions.

Different US regulators can pursue the same conduct at the same time under the same theories of liability. Or a criminal prosecution may follow settlement of SEC civil charges.

What impact does the Sarbanes-Oxley Act have on our situation?

Although Sarbanes-Oxley has attracted a significant amount of interest in connection with securities fraud issues, the most significant impact of the legislation and the SEC rulemaking that followed, in terms of corporate behavior, was on internal processes, the relationship among management, the audit committee and the external auditors and disclosure. The Act did create or increase criminal penalties and/or civil monetary penalties for securities fraud, misleading auditors, obstruction of justice and whistle-blower retaliation, but from a liability standpoint, many of the bases for liability remain the traditional ones.

That having been said, each of the gatekeepers is under greater scrutiny, and their concerns, particularly in egregious cases, need to be factored into any response. The CEO and CFO will be concerned about the impact of any investigation on their personal certifications, the company’s disclosure committee will be concerned with lapses in its procedures, the audit committee will be concerned with whether procedures mandated by the Act or adopted as a matter of best practices were circumvented, US securities counsel will be concerned with whether they had missed facts that warranted “reporting up” and the auditors may themselves be bracing for an inquiry into their role.

What else do I need to keep in mind?

The Sarbanes-Oxley Act bolstered protection of whistle-blowers and increased penalties for retaliation.

The auditors have their own duties in the event they discover material fraud in the course of an audit. They are under duties to report to management and the audit committee. If, after informing the audit committee, the auditors conclude that the company has not taken “timely and appropriate remedial action” they must report up to the board. Upon receiving such a report, the board has one business day to report to the SEC, failing which the auditors must resign and report, or just report, the matter to the SEC.

How can I be better prepared?

Most SEC sanctions for lack of cooperation are due to late, untimely or simply obstructionist provision of information. Knowing this should allow the CLO to have plans in place to work quickly and effectively with the SEC.

Companies that do not have effective compliance programs in place proceed at their own risk. In addition to minimizing the likelihood that fraudulent conduct will occur, compliance programs can be of tremendous value if fraud does in fact occur. Such policies will be an essential element of the SEC's view of cooperation. Their importance was further underscored in the recent amendments to the US Sentencing Guidelines, which explicitly and substantially reward companies that have adopted an effective compliance program, prior to an offense, even if the program ultimately did not succeed in preventing fraud. If the company has a track record of identifying and properly responding to fraudulent behavior in the past, the company is in a much better position than to have no effective program to point to.

The compliance program must clearly promote a culture that encourages ethical conduct and a commitment to compliance with applicable law. The tone must be set at the top. Continuing to borrow from the US Sentencing Guidelines:

- The Board must be knowledgeable about the content and operation of the program and should exercise reasonable oversight over implementation of the program.
- Someone in senior management must have overall responsibility for the program, even though management may delegate operational responsibility for the program to a person outside senior management.
- Those with operational responsibility for the program must have adequate resources, appropriate authority and direct access to the Board to carry out their responsibilities.
- All employees, including senior management, and the Board should receive training, which is updated periodically.
- Companies must have in place a system, which should include anonymous and confidential reporting mechanisms, through which employees can report, or seek guidance, regarding potential or actual criminal conduct, without fear of retribution. Note that, as a public reporting company in the US, the company's audit committee is responsible for ensuring that a system is in place for confidential reporting of conduct.

An essential element of any such compliance program is a document retention policy that completely and unambiguously freezes all destruction of documents and other records in the face of an investigation. This suspension needs to cover the full range of documents and other records, whether they are in hard copy or in electronic format, whether they are on company servers, PDAs, wireless communication devices, laptops or home computers. In some cases, IT systems will need to be overridden to halt automatic document destruction such as e-mail deletions. Document preservation orders, including to IT and records departments and managers, must be up to date; this means knowing how and where records are kept and destroyed and being able to quickly gather, and prevent the destruction of, documents and other records that the SEC is likely to request.

What should be on my checklist?

One could divide the checklist into two parts, what comes first should an investigation be launched, and what should you be doing now to minimize the likelihood that the first checklist will be needed.

As to the response to an investigation:

1. Issue the necessary record preservation notices.
2. Try to ascertain the scope of the investigation. Try to glean as much from the questions posed by the Staff.
3. Agree on a public disclosure strategy. If no disclosure now, consider when disclosure should be made, and ensure that the policy is rigidly adhered to.
4. Communicate the company's willingness to cooperate with the SEC Staff.
5. Prepare for the document production exercise.
6. Consider the need for, and identify, independent counsel to undertake an investigation.

As to preventative steps:

1. Review with the Board and senior management the company's compliance and ethics program.
2. Ensure that adequate training is provided for all employees (regardless of seniority) and Board members on the operation of the company's compliance and ethics program.
3. Maintain a log of instances when the compliance program affirmatively worked.
4. Ensure that crisis management procedures have been thought through and that there is system in place to ensure that the CLO is informed of all regulatory inquiries, including receipt of any subpoena, requests for employee interviews, informal requests for documents or other information, and any other informal questioning.
5. Review, and adjust if necessary to reflect the practical aspects of the company's storage arrangements and IT platforms, the records retention policies to ensure immediate and effective suspension of all record destruction and that document production requests can be responded to quickly and efficiently.

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This memorandum provides only a general overview of certain provisions of the Act and is not intended to provide or constitute legal advice, and no legal or business decision should be based on its contents. For further information concerning the subject matter of this memorandum, please contact:

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