



SEC Enforcement and Internal Investigations

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Overview

- Hypothetical fact pattern
- Key issues
- SEC Enforcement Division and its practices
- Conducting an internal investigation
- To cooperate or not to cooperate?

Hypothetical Fact Pattern

- You represent XYZ Corp., a public company
- General Counsel calls
 - Anonymous letter received by company
 - Company is invoicing and shipping products to distributors, just prior to the end of the quarter
 - Distributors had not ordered products
 - Products returned by distributors early in the new quarter
- What, asks the GC, should I do?

Key Issues

- Key Issues for clients and their counsel faced with allegations/evidence of misconduct
 - Conduct an internal investigation?
 - If so, in what form?
 - Self-report to SEC?
 - Cooperate with SEC investigation?
 - Waive privilege?

SEC Enforcement Division and its Practices

- Snapshot of SEC's Enforcement Division
 - Resources limited
 - 1,100 employees in enforcement nationwide -- including professional and non-professional
 - 11 regional offices
 - 671 enforcement actions in FY 2008
 - Second highest in SEC history
 - Division must pick and choose cases carefully
 - Can't do it all
 - Investigations are labor-intensive
 - Exercise of prosecutorial discretion often follows trends

SEC Enforcement Division and its Practices

- Traditional subjects of SEC enforcement actions
 - Financial fraud and disclosure
 - Accounting fraud
 - Insider trading
 - Market manipulation
- Wall Street vs. “Main Street”

SEC Enforcement Division and its Practices

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- Hot targets in the past several years:
 - FCPA a high priority, typically in conjunction with DOJ
 - Stock options backdating
 - Now winding down

SEC Enforcement Division and its Practices

- Current priorities
 - Subprime/credit crisis
 - Few actions filed as of yet
 - Anecdotal evidence indicates as many as 50 investigations have been opened
 - Hedge funds
 - SEC v. Ralph Cioffi and Matthew Tannin
 - Former hedge fund managers for Bear Stearns
 - Also subject to criminal prosecution by DOJ
 - Managed Bear Stearns hedge funds that were heavily invested in subprime investments
 - As value of investments plummeted in spring of 2007, SEC contends that defendants misled investors as to value of subprime investments

SEC Enforcement Division and its Practices

- Auction rate securities
 - SEC v. Julian Tzolov and Eric Butler
 - Former brokers for Credit Suisse
 - Also subject to criminal prosecution by DOJ
 - Solicited clients to purchase auction rate securities backed by conservative student loan issues, guaranteed by US Department of Education
 - Brokers also purchased more dangerous investments, according to SEC, which were backed by subprime mortgages and collateralized debt obligations

SEC Enforcement Division and its Practices

- Remedies
 - Twenty years ago, before Remedies Act of 1990, SEC typically sought injunctions
 - court orders prohibiting future violations
 - Stakes now much higher
 - civil monetary penalties
 - disgorgement
 - monitors

SEC Enforcement Division and its Practices

- Significantly higher civil penalties
 - Before SOX, largest civil penalty against non-broker/dealer was \$10 million against Xerox
 - Next highest -- \$1 million against Sony
 - SEC reluctant to punish shareholders
- SOX permits penalties to be paid into fund for distribution to shareholders
 - \$750 million against Worldcom
 - \$715 million against Adelphia
 - \$300 million against Time Warner

SEC Enforcement Division and its Practices

- Monitors
 - SEC has increasingly insisted on appointment of monitors
 - typically in conjunction with DOJ
 - Monitor has extensive authority to review company operations, often for 3 year term
 - companies subject to monitorships
 - AOL Time Warner
 - KPMG
 - Bristol Myers Squibb
 - Monsanto
 - Mellon Financial Corp.

SEC Enforcement Division and its Practices

- The Enforcement Manual
 - From 1934 until October 2008, no written policies or procedures governed Enforcement Division's conduct of investigations
 - October 2008, SEC issued Enforcement Manual
 - Addresses multitude of topics:
 - Standards for commencing investigations
 - Low threshold for opening “matter under inquiry”
 - Do facts indicate there is “potential to address conduct that violates the federal securities laws?”
 - Higher threshold for opening “investigation”
 - “Will the investigation have the potential to substantively and effectively address violative conduct?”
 - Formal Order of Investigation
 - Issued upon determination by the Commission that “a violation of the federal securities laws may have occurred or may be occurring”

SEC Enforcement Division and its Practices

- The Enforcement Manual (cont'd)
 - Mandates regular review of open investigations
 - Wells process
 - Allows recipient of Wells notice to review non-privileged portions of investigative file, in order to frame arguments
 - Provides for termination notices upon staff decision not to recommend enforcement action

SEC Enforcement Division and its Practices

- The Enforcement Manual (cont'd)
 - Also addresses two issues that have proven controversial this decade
 - Cooperation and waiver of privilege
 - Conduct of parallel proceedings with DOJ
 - Investigative steps must be taken to advance the civil action
 - Not solely to advance the parallel criminal investigation

Conducting an Internal Investigation

- How the issue may arise
 - SEC occasionally commences enforcement proceedings without any notice, but . . .
 - Often, the client will learn of problem itself
 - Internal compliance generates red flag
 - Internal allegations of misconduct
 - Whistleblower
 - Auditor raises issue
 - Civil lawsuit raises possible regulatory issue
 - Subpoena

Conducting an Internal Investigation

- Should the client conduct an internal investigation?
 - Generally advisable to conduct immediate internal investigation
 - Must ascertain whether client has a problem
 - Determine scope/seriousness of problem
 - Take appropriate remedial action
 - Get in front of regulators/possible public disclosure
 - May wish to self-report
 - Create record of diligence in event of Government investigation
 - Section 307 of SOX requires an attorney representing an issuer to report -- to chief legal officer and possibly directors -- evidence of material violation of securities laws
 - Do it right

Conducting an Internal Investigation

- If conducting an investigation . . .
 - Who is client?
 - Company
 - Not individual employees/officers
 - Civil *Miranda* warnings
 - Company's privilege to waive
 - Responding to employee questions
 - “Should I get my own lawyer?”
 - “Do I have to cooperate?”

Conducting an Internal Investigation

- To whom does counsel report?
 - General Counsel?
 - Any involvement in conduct under investigation?
 - Audit committee of Board
 - Special committee of independent directors
 - Considerations. Recipient of report should have:
 - Appropriate authority to act on results of investigation
 - Independence from wrongdoing and wrongdoers
 - Perception of independence by outsiders/regulators

Conducting an Internal Investigation

- Who should conduct internal investigation?
 - In-house counsel
 - Rapport with employees
 - Access to witnesses and records
 - Knowledge of company practices
 - Outside counsel
 - Independent judgment
 - Viewed as impartial by regulators
 - Greater likelihood of attorney-client privilege and work product protection

Conducting an Internal Investigation

- Preserving the attorney-client privilege
 - Critical to focus on privilege from day one
 - Get counsel involved immediately
 - Counsel should conduct interviews
 - Direct gathering of documents
 - Direct others involved in investigation

- Critical to preserve documents
 - Preserve integrity of investigation
 - Avoid later allegations of obstruction/spoliation
 - Issue document preservation directive immediately

Conducting an Internal Investigation

- Prepare a written report?
 - Pros
 - create record of scope of investigation
 - tool to assist management in planning remediation
 - Cons
 - Government will press for disclosure
 - Civil litigants will seek production in civil litigation

To Cooperate or Not to Cooperate?

- Key issue: to self-disclose or not to self-disclose?
 - Pros: get credit for self-reporting in any discussions with government concerning possible charges or penalties
 - Cons: disclosing conduct to government that it might not otherwise learn
 - Prior DOJ policy -- as reflected in Thompson Memorandum -- weighed heavily in favor of such cooperation
 - voluntary cooperation and disclosure of information a key factor used by DOJ in determining whether to charge corporation
 - Prior SEC policy -- as reflected in the 2001 Seaboard Report -- also weighed heavily in favor of cooperation

To Cooperate or Not to Cooperate?

- Waiver of attorney-client privilege
 - Cooperation with the government typically meant waiver of attorney-client and work product protection and full disclosure of facts to the government
 - Government viewed decision not to waive as failure to cooperate -- and took such failure into account in decision whether to charge corporation

To Cooperate or Not to Cooperate?

- Selective Waiver
 - Among other dilemmas, this raised problem of selective waiver
 - Can corporation waive as to government without waiving as to subsequent civil litigants?
 - Generally: no
 - SEC has been willing to enter into confidentiality agreement prohibiting disclosure of reports to third parties
 - Case law mixed on effectiveness of confidentiality agreement
 - Recent amendment of Rule 502 declined to address selective waiver, leaving current law in place

To Cooperate or Not to Cooperate?

- The Filip Guidelines
 - Recent announcement by DOJ appears to give corporations more latitude to push back and not waive privilege
 - Guidelines replace Thompson Memorandum and its successor, the McNulty Memorandum
 - Credit for cooperation will not depend on whether a corporation has waived attorney-client or work-product protection
 - Prosecutors generally prohibited from requesting that companies disclose non-factual attorney-client privileged communications or attorney work product

To Cooperate or Not to Cooperate?

- SEC Manual follows Filip Guidelines
 - Recently issued SEC enforcement manual adopts same policy as Filip guidelines
 - Waiver of privilege is not a prerequisite to obtaining credit for cooperation
 - “The staff should not ask a party to waive the attorney-client or work product privileges and is directed not to do so.”

To Cooperate or Not to Cooperate?

- Still pressure to cooperate
 - Even with these new DOJ and SEC policies, clients must give serious consideration to self-disclosing unlawful conduct
 - Government will certainly take disclosure into account, along with remedial measures, in deciding
 - whether to bring charges
 - amount of penalties sought