Chapter 5

The Role of Corporate Internal Investigations

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§ 5:1 Overview

It is a fact of life that regulatory and criminal authorities are closely examining corporate entities for signs of wrongdoing. The Securities and Exchange Commission (SEC), Department of Justice (DOJ), the Financial Industry Regulatory Authority (FINRA), and state attorneys general regularly launch investigations into alleged corporate misconduct. Further, both state and federal regulators and prosecutors have the ability to seek or impose penalties on corporate entities

designed to punish any uncovered wrongdoing. Civil penalties or—even worse—a criminal conviction can have a devastating impact on a corporation. Sticking one's metaphorical head in the sand and hoping that the problem will go away is never an effective strategy and individuals and corporations can, and have, paid a heavy price for inaction.

A company's best defense to the threat presented by a regulatory or criminal investigation is to master the relevant facts surrounding the alleged misconduct and make informed use of those facts before the government arrives on the scene. Such knowledge puts the company in a position to (1) assess whether the allegations of misconduct have merit and, if so, determine the extent of the misconduct and how to address it; (2) undertake any necessary remedial measures designed to guard against recurrences of the misconduct; and (3) make an informed decision about whether to disclose the misconduct to the authorities and cooperate in any ensuing government investigation. These actions will allow the company to argue credibly that it has appropriately addressed the misconduct allegations and therefore is entitled to credit or leniency from the authorities.

Regulators and prosecutors have published guidance that sheds light on the nexus between a prompt and thorough internal investigation and a positive outcome at the end of a government inquiry. In general, these guidelines adopt a carrot-and-stick approach. The stick is used to punish companies that fail to promptly and thoroughly investigate allegations of misconduct. The carrot is reserved for those that can demonstrate that they promptly investigated allegations of misconduct and genuinely attempted to remediate any institutional or personnel issues. This chapter examines the role of the corporate internal investigation in light of the guidance offered by the various governmental and regulatory constituencies to which a company may be subject.[1]

§ 5:2 The Constituencies for an Internal Investigation

A successful internal investigation can have many salutary business benefits—by improving internal controls identifying potential trouble spots, and ferreting out untrustworthy employees who present risk to the company. Ultimately, however, almost all internal investigations are carried out with some regulatory constituency in mind. From the beginning, the investigation should be conducted bearing in mind that some of the information from the internal investigation may be shared with the relevant regulator in order to persuade that

1. This chapter focuses on guidance offered by the SEC, DOJ, the Federal Sentencing Guidelines, FINRA, SOX, and New York State's Martin Act.

regulator that the company acted promptly and appropriately when it became aware of an internal problem.

Public companies, and regulated entities, are subject to a complex network of rules and statutes, and report to many regulators, each of whom may expect different responses as a result of an internal investigation. It is important to consider at the earliest possible moment how an internal investigation should be structured, and whether and how information should be reported in light of the regulators involved.

Statutory provisions such as the Sarbanes-Oxley Act of 2002[2] ("Sarbanes-Oxley") continue to provide the main impetus for performing an internal investigation when malfeasance is suspected. When an internal investigation or other action is compelled by statute, there is no decision to make as to *whether* an investigation is commenced; the focus instead is on determining the scope and purpose of the investigation. We discuss statutory concerns below in section 5:3.

For a public company or a regulated entity such as a broker-dealer, the SEC is the regulator whose attention is most likely to provoke a large-scale internal investigation conducted by outside counsel. Ideally, such an investigation will have been commenced before inside counsel receives a letter from the SEC announcing an investigation. The guidance offered by the SEC, with examples of cases resolved under that guidance, is discussed below in section 5:4.

Less common—but far more worrisome—is attention from the DOJ. If the SEC has referred the matter to the DOJ, or if the DOJ has opened an investigation on its own initiative, the stakes have been raised considerably. Criminal sanctions as well as civil fines or penalties are now a possibility, and it is more important than ever to make a compelling case that the company diligently and resolutely sought to police itself. DOJ's policies regarding internal investigations, and the results of that guidance, are discussed below in section 5:5.

Many, if not most, of the day-to-day regulatory concerns of a regulated entity arise because of that entity's obligations to a Self-Regulatory Organization. The primary example is FINRA. Although the potential consequences of a FINRA investigation are generally not as dire as those of an SEC or DOJ investigation, FINRA expects a very high degree of cooperation from its members. FINRA guidance as it relates to internal investigations is discussed below in section 5:6.

Finally, given the increased role of state attorneys general in investigating corporate wrongdoing, we briefly discuss the role of the internal investigation in the context of state proceedings. It would be impossible in this chapter to review the practices of all fifty states,

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2. *See infra* section 5:3.2.

but we address one significant tool of New York regulators below in section 5:7.

§ 5:3 Statutory Provisions Implicating Internal Investigations

§ 5:3.1 *Generally*

Sarbanes-Oxley[3] was the principal legislative response to the numerous corporate and accounting scandals that occurred between 2000 and 2002. Several provisions of Sarbanes-Oxley require companies to commence internal investigations, or create significant incentives for them to do so. Certain other statutory provisions require disclosures or investigations in some circumstances, and a provision of Title 18 ("Crimes and Criminal Procedure") provides whistleblower protections for employees who assist in regulatory or internal investigations.

§ 5:3.2 *The Sarbanes-Oxley Act*

[A] Generally

Sarbanes-Oxley applies to issuers of securities registered under section 12, entities that are required to file reports under section 15(d) of the Exchange Act, and entities with a not-yet-effective registration under the Securities Act. That is, as a practical matter, it applies to all public companies or companies in the process of going public. Several provisions of Sarbanes-Oxley impose obligations that encourage or require companies to conduct internal investigations.

Sarbanes-Oxley imposes specific duties not only on the company, but also on specific officers, directors and agents of the company who have a role in compliance or financial reporting. It further motivates these individuals to ensure the accuracy of the company's public filings by imposing upon them the possibility of personal liability. Section 3 of Sarbanes-Oxley (15 U.S.C. § 7202) does this generally by subjecting persons who violate Sarbanes-Oxley to liability "in the same manner as a violation of the Securities Exchange Act of 1934." There is also the possibility of additional civil liability specific to certain officers.

[B] Duties of the Audit Committee

Section 301 of Sarbanes-Oxley (codified at 15 U.S.C. § 78j-1) added certain requirements to section 10A of the Exchange Act related to

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3. Sarbanes-Oxley Act, Pub. L. No. 107-204, 116 Stat. 745 (codified at 15 U.S.C. §§ 7201 *et seq.*).

the powers and duties of public companies' audit committees. This provision requires that public companies have an audit committee comprised of independent board members, and that the committee establish procedures for:

- Handling complaints regarding accounting, internal accounting controls, or auditing matters; and
- Allowing employees to anonymously report concerns regarding questionable accounting or auditing matters.

These are the sorts of issues that often spur an internal investigation. Indeed, unless the complaints or concerns are patently frivolous, some kind of investigation is generally necessary to determine whether there has been any misconduct by a company employee and whether remediation, self-disclosure, or even a financial restatement is required.

The audit committee is charged with the oversight and ultimate responsibility for all aspects of the investigation, including its initiation, conduct and, ultimately, the decision whether, when, and how to report its findings to the SEC.[4] Among the initial decisions will be whether outside counsel should be engaged to conduct the investigation; the statute requires the audit committee to have authority to engage independent counsel and other advisers as it deems necessary to carry out its duties, and it requires the company to provide appropriate funding (as determined by the audit committee) for payment of compensation to those advisers.[5]

As a practical matter, the decisions of whether and when inside counsel and management should elevate problems discovered internally to the audit committee, and whether the audit committee should engage outside counsel to conduct an investigation, are often the first ones a company will face when wrongdoing is suspected. When considering these issues, companies, audit committees, and their legal advisers must be sensitive to the fact that how promptly and vigorously they respond to an initial report of possible wrongdoing will be a factor in how regulators assess corporate culpability.

[C] Duties of the Chief Executive Officer and Chief Financial Officer

Section 302 of Sarbanes-Oxley (codified at 15 U.S.C. § 7241) is one with which most chief executive officers (CEOs) and chief financial officers (CFOs) are intimately familiar. It requires each of these officers to certify in the company's periodic reports (among other things)

4. 15 U.S.C. § 78j-1(b)(3).
5. 15 U.S.C. § 78j-1(m)(5)–(6).

that "the report does not contain any untrue statement of a material fact or omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which such statements were made, not misleading." This section also imposes upon these officers the further responsibility to see that:

- The company's internal controls are adequate to bring to their attention any material information;
- They have evaluated those controls;
- They have reported to the company's auditors and to the company's audit committee any significant deficiencies in the internal controls, and any fraud related thereto; and
- They have reported to the company's auditors and to the company's audit committee any fraud, whether or not material, that involves management or other employees who have a significant role in the issuer's internal controls.

These provisions create a powerful incentive for the CEO and CFO to investigate diligently any known or suspected wrongdoing brought to their attention. A failure to do so may subject them to individual liability.

In addition to the general duty this section creates, section 304 of Sarbanes-Oxley specifically creates a mechanism whereby, following a restatement necessitated by "misconduct," the CEO and CFO can be compelled to pay back to the company "any bonus or other incentive-based or equity-based compensation received" in the twelve months prior to the restated period. This clawback provision is in addition to any ordinary liability for civil fraud to private individuals or as a result of enforcement action by the SEC or the DOJ, and creates another powerful incentive for these officers to ensure that they have addressed any wrongdoing within the organization.

[D] Duties of Auditors

Under section 404 of Sarbanes-Oxley (codified at 15 U.S.C. § 7262), a public company's annual report must also include an assessment of the effectiveness of the company's internal accounting controls. The company's auditor must "attest to, and report on, the assessment made by the management of the issuer." This attestation must comply with standards adopted by the Public Company Accounting Oversight Board (PCAOB).[6] While a material weakness in the controls

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6. 15 U.S.C. § 7262. It is worth noting that the standards promulgated by the PCAOB remain fully operative after the U.S. Supreme Court's decision in Free Enter. Fund v. Pub. Co. Accounting Oversight Bd., 561 U.S. 477 (2010).

framework will preclude an unqualified opinion that internal controls are effective, it is still possible for the audit committee to issue an unqualified opinion regarding the company's financial statements; significant deficiencies in controls do not necessarily translate into financial misstatements.

Section 204 of Sarbanes-Oxley amends section 10A of the Exchange Act to expressly require auditors to report certain things to the company's audit committee, including "alternative treatments of financial information within generally accepted accounting principles that have been discussed with management officials of the issuer, ramifications of the use of such alternative disclosures and treatments, and the treatment preferred by the registered public accounting firm."

[E] Duties of Lawyers

Section 307 of Sarbanes-Oxley (codified at 15 U.S.C. § 7245), and the SEC rules promulgated thereunder, created the regime now generally known as "up-the-ladder reporting." Upon becoming aware of a possible material violation, an issuer's lawyers are obligated to initiate an internal investigation by reporting their suspicions of possible material violations of law up the corporate ladder to the company's chief legal officer and CEO.[7] Upon receiving such a report, the company's chief legal officer must "cause such inquiry into the evidence of

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In that case the Supreme Court, by a 5–4 majority, invalidated as unconstitutional the provisions of Sarbanes-Oxley that governed how the SEC could remove members of the PCAOB. Under the statute, the members of the PCAOB could be removed from office by the SEC Commissioners under a stringent for cause standard. *See* 15 U.S.C. §§ 7211(e)(6), 7217(d)(3). SEC Commissioners, in turn, are removable from office by the President only for cause, as well. The Court held that this administrative scheme involving two layers of for cause removal between the President and the members of the PCAOB violated the principle of separation of powers by "subvert[ing] the President's ability to ensure that the laws [were] faithfully executed[.]" *Free Enter.*, 561 U.S. at 498. As a remedy, the Court excised these removal provisions from Sarbanes-Oxley, rendering the members of the PCAOB removable at will by the SEC Commissioners.

The Court, however, declared that the remaining provisions of Sarbanes-Oxley remain in force. *See id.* at 508–10. Thus, for example, section 105 of Sarbanes-Oxley, which gives the PCAOB its own investigative and disciplinary powers over public accountants, including the authority to impose considerable sanctions, is still on the books. *See* 15 U.S.C. § 7215.

7. *See* 17 C.F.R. § 205.3(b)(1) ("If an attorney, appearing and practicing before the SEC in the representation of an issuer, becomes aware of evidence of a material violation by the issuer or by any officer, director, employee, or agent of the issuer, the attorney shall report such evidence

a material violation as he or she reasonably believes is appropriate to determine whether the material violation described in the report has occurred, is ongoing, or is about to occur."[8]

After this inquiry is complete, the chief legal officer must take one of two steps: if he or she believes that no violation has occurred, that determination, and the basis for it, must be presented to the attorney who initially reported the possible violation.[9] The reporting attorney must then decide whether the chief legal officer and CEO "have provided an appropriate response within a reasonable time."[10] If not, the reporting attorney must submit his or her evidence concerning the possible violation:

(i) to the audit committee; or if the company has no audit committee,

(ii) to the company's outside directors; or if there are no outside directors,

(iii) to the entire board.[11]

These requirements essentially require a company's chief legal officer to initiate a formal investigation in response to any allegation of wrongdoing falling within the up-the-ladder reporting obligation that comes to the attention of a lawyer for the company. If internal counsel believes these provisions of SOX are implicated, it is important to carefully document compliance with the statute and regulations, and to seriously consider obtaining advice from outside counsel.

§ 5:3.3 Duties with Respect to Employees

Section 804 of SOX (18 U.S.C. § 1514A) created enhanced protections for corporate whistleblowers who disclose information related to violations of the securities laws. Statutory protections extend not only to employees who provide information to the government in the context of a formal or informal investigation, but also to those who

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to the issuer's chief legal officer . . . or to both the issuer's chief legal officer and its chief executive officer."). Where appropriate, this evidence may also be reported directly to the company's legal compliance committee. *See* 17 C.F.R. § 205.3(c)(1).

8. *See* 17 C.F.R. § 205.3(b)(2). Alternatively, the chief legal officer may refer the matter immediately to the company's legal compliance committee. *See id*.

9. *See id.*

10. 17 C.F.R. § 205.3(b)(3).

11. 17 C.F.R. § 205.3(b)(3). The reporting attorney may also turn directly to these persons if he or she believes it would be futile to first turn to the chief legal officer and CEO. *See* 17 C.F.R. § 205.3(b)(4).

provide information to "a person with supervisory authority over the employee (or such other person working for the employer who has the authority to investigate, discover, or terminate misconduct)."

In addition, section 1107 of SOX amends 18 U.S.C. § 1513 to add *criminal* penalties for adverse employment actions in retaliation for assisting federal law enforcement officers, including up to ten years imprisonment.

The significance of this provision is that whistleblowers are protected from adverse employment consequences not only for providing information to the government, but also to superiors, audit committee members, or counsel or other professionals working on their behalf. It is important to handle both the information provided by whistleblowers, and the whistleblowers themselves, with care. An employee who reports possible misconduct, and who subsequently suffers any adverse employment action, may have a powerful weapon at his or her disposal.

In 2011, the whistleblower provisions of the Dodd-Frank Act became effective. These provisions incentivize the reporting of potential securities violations to the SEC by making whistleblowers eligible for an award between 10% to 30% of any monetary recovery in cases where the whistleblower's original information leads to a successful SEC action resulting in monetary sanctions exceeding $1 million. The whistleblower is not required to report the securities violation internally before contacting the SEC, but reporting internally first may result in an increased award to a whistleblower. Since the program's inception, the SEC has paid more than $266 million to fifty-five individuals.[11.1] On March 19, 2018, the SEC announced its highest whistleblower awards to date, with two whistleblowers sharing a nearly $50 million award and a third whistleblower receiving more than $33 million.[11.2] In 2014, the SEC brought its first enforcement action under the non-retaliation provision of the statute. Recent enforcement actions confirm that the SEC will issue awards to whistleblowers with compliance or audit-related responsibilities. Moreover, in 2015, the SEC followed through on earlier warnings by bringing an enforcement action against a company that required employees to enter into confidentiality agreements that were perceived as deterring employees from reporting suspected misconduct. Companies are now well advised to review their confidentiality policies and severance agreements, and to revise language that may be viewed as overly restrictive.[12]

11.1. Press Release, 2018-64 (Apr. 12, 2018).

11.2. Press Release, 2018-44 (Mar. 19, 2018).

12. SEC, 2014 Annual Report to Congress on the Dodd-Frank Whistleblower Program, at 2–3.

§ 5:4 SEC Guidance Relating to Internal Investigations

For almost a decade, the SEC has issued occasional guidance regarding the criteria it uses to decide whether to commence enforcement proceedings against a company. The details have varied, but one basic principle is consistent—when it comes to self-policing and self-reporting, more and earlier are better.

§ 5:4.1 The Seaboard Report

In 2001, the SEC issued the "Seaboard Report," describing the results of an investigation pursuant to section 21(a) of the Exchange Act. The SEC used the Seaboard Report to outline some of the criteria that it would consider in deciding whether to bring an enforcement action against a company.[13] The Seaboard Report established standards and expectations regarding internal investigation and self-reporting that remain important today, and indeed have been recently reaffirmed by the SEC.

Critically, the role of the company's self-policing efforts and the degree of its cooperation with law enforcement officials featured prominently in the SEC's discussion. Specifically, the Seaboard Report identified four broad factors that influence the SEC's evaluation of a company's cooperation:

- self-policing prior to the discovery of the misconduct, including the establishment of effective compliance procedures and an appropriate tone with respect to compliance at the top of the organization;
- self-reporting of misconduct upon discovery, including conducting a thorough review of the nature, extent, origins, and consequences of the misconduct, and prompt, complete, and effective disclosure to the public, regulators, and Self-Regulatory Organizations;
- remediation, including the dismissal or appropriate discipline of individual wrongdoers, the modification of internal controls and compliance procedures to prevent recurrence, and the compensation of those adversely affected; and
- cooperation with law enforcement authorities, including providing the SEC staff with all information relevant to the underlying violations and the company's remedial efforts.[14]

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13. Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934 and SEC Statement on the Relationship of Cooperation to Agency Enforcement Decisions, Exchange Act Release No. 44969 (Oct. 23, 2001) [hereinafter Seaboard Report], www.sec.gov/litigation/investreport/34-44969.htm.
14. *Id.*

While making clear that it was not adopting a rule or limiting its enforcement discretion, the SEC indicated that, where a company takes the steps outlined in the Seaboard Report, it may "credit" the company for its remedial efforts in an exercise of its discretion. Such "credit for cooperative behavior," the SEC explained, "may range from the extraordinary step of taking no enforcement action at all to bringing reduced charges, seeking lighter sanctions, or including mitigating language in documents the SEC uses to announce settled enforcement actions." To make these general principles concrete, it is useful to examine the conduct that the SEC felt justified the "extraordinary step" of taking no enforcement action against the company:

> We are not taking action against the parent company, given the nature of the conduct and the company's responses. Within a week of learning about the apparent misconduct, the company's internal auditors had conducted a preliminary review and had advised company management who, in turn, advised the Board's audit committee, that Meredith had caused the company's books and records to be inaccurate and its financial reports to be misstated. The full Board was advised and authorized the company to hire an outside law firm to conduct a thorough inquiry. Four days later, Meredith was dismissed, as were two other employees who, in the company's view, had inadequately supervised Meredith; a day later, the company disclosed publicly and to us that its financial statements would be restated. The price of the company's shares did not decline after the announcement or after the restatement was published. The company pledged and gave complete cooperation to our staff. It provided the staff with all information relevant to the underlying violations. Among other things, the company produced the details of its internal investigation, including notes and transcripts of interviews of Meredith and others; and it did not invoke the attorney-client privilege, work product protection or other privileges or protections with respect to any facts uncovered in the investigation.
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> The company also strengthened its financial reporting processes to address Meredith's conduct—developing a detailed closing process for the subsidiary's accounting personnel, consolidating subsidiary accounting functions under a parent company CPA, hiring three new CPAs for the accounting department responsible for preparing the subsidiary's financial statements, redesigning the subsidiary's minimum annual audit requirements, and requiring the parent company's controller to interview and approve all senior accounting personnel in its subsidiaries' reporting processes.[15]

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15. *Id.*

The SEC's description of the facts that led it to forgo enforcement action illustrates the three key aspects of an effective internal investigation: (1) the company promptly and vigorously investigated the facts and took decisive disciplinary action with respect to the employees involved; (2) the company cooperated fully with the SEC staff and provided complete disclosure; and (3) the company adopted policies intended to remediate the weaknesses that led to the problem. The Seaboard Report went on to list thirteen specific criteria relevant to the SEC's decision whether to recommend enforcement action:

- the nature of the misconduct;
- the way in which the misconduct arose;
- the locus of the misconduct within the organization;
- the duration of the misconduct;
- the level of harm inflicted upon investors and other corporate constituencies and whether the company's share price dropped significantly upon its disclosure;
- the manner in which the misconduct was detected and who uncovered it;
- the rapidity of the company's post-discovery response;
- the steps taken by the company upon learning of the misconduct;
- the processes followed by the company in resolving the issues raised by its discovery;
- whether the company fully and expeditiously committed to learning the truth;
- whether the company promptly reported the results of its review to the SEC staff and provided sufficient documentation reflecting its response to the situation;
- whether there are assurances that the misconduct is unlikely to recur; and
- whether the company in which the misconduct occurred has undergone a fundamental corporate change such as a merger or bankruptcy reorganization.[16]

The prominent role that a well-run internal investigation can play is self-evident both from the SEC's discussion of the actions taken by the company to avoid enforcement action and by the specific criteria enumerated in the report.

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16. *Id.*

§ 5:4.2 Principles for Imposing Monetary Penalties

Several years after the Seaboard Report, the SEC further clarified its enforcement posture with respect to monetary penalties. In 2006, the SEC took the unusual step of issuing a press release announcing the principles that it would consider when determining whether and to what extent such penalties should be imposed.[17]

In his speech announcing the Penalties Statement, then-Chairman Christopher Cox emphasized that it is the SEC's "intention that these principles will establish objective standards that will provide the maximum degree of investor protection." The Penalties Statement outlined two principal factors that the SEC will take into account in deciding whether to impose monetary penalties, along with seven other secondary factors. The principal factors are:

- The presence or absence of a direct benefit to the corporation as a result of the violation, such as reduced expenses or increased revenue. Similarly, a monetary penalty would be appropriate if the issuer is in any other way "unjustly enriched."[21] Monetary penalties are most appropriate where shareholders have "received an improper benefit as a result of the violation."

- The degree to which the penalty will recompense or further harm the injured shareholders. The SEC stated that, notwithstanding that the "imposition of a penalty on the corporation itself carries with it the risk that shareholders who are innocent of the violation will nonetheless bear the burden of the penalty," in certain cases, it is appropriate to seek and obtain a monetary penalty because the penalty may be "used as a source of funds to recompense the injury suffered by victims of the securities law violations." However, the "likelihood a corporate penalty will unfairly injure investors, the corporation, or third parties weighs against its use as a sanction."

Included among these secondary factors are two that bear directly on the decision to conduct an internal investigation, and how it should be conducted:

- the presence or absence of remedial steps by the issuer in deciding whether to impose a monetary penalty, and

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17. Press Release, SEC, Statement of the Securities and Exchange Commission Concerning Financial Penalties (Jan. 4, 2006), [hereinafter SEC Press Release], www.sec.gov/news/press/2006-4.htm.
18.–20. [Reserved.]
21. SEC Press Release, *supra* note 17.
22. [Reserved.]

- the degree to which a corporation has self-reported an offense or otherwise cooperated with the investigation and remediation of the offense.

§ 5:4.3 The SEC's "Cooperation Initiative"

[A] Generally

On January 13, 2010, the SEC "announced a series of measures to further strengthen its enforcement program by encouraging greater cooperation from individuals and companies in the agency's investigations and enforcement actions."[23] These new policies, referred to as the "Cooperation Initiative," do not change any of the factors regarding corporate charging decisions described in the Seaboard Report. Rather, they aim to create additional incentives for cooperation, particularly by individuals who have knowledge of violations of the securities laws. According to Robert Khuzami, the then-Director of the Division of Enforcement ("Division"), these initiatives were potentially a "game changer" for the Division.

[B] Cooperation Tools

The three types of agreements that the SEC may use to resolve enforcement matters are borrowed from DOJ practice:

Cooperation Agreements. A cooperation agreement is a written agreement between the Division and a potential cooperating individual or company. The Division agrees to recommend to the SEC that a cooperator receive cooperation credit in an investigation or related enforcement action on the condition that the individual or company provides substantial assistance to the SEC's investigation or related enforcement action.

Deferred Prosecution Agreements (DPAs). A DPA is a written agreement between the SEC and a potential cooperating individual or company in which the SEC files an enforcement action but agrees to forego prosecution of that action if that individual or company agrees to, among other things, (i) cooperate with the SEC's investigation, (ii) enter into a long-term tolling agreement, and (iii) agree to admit underlying facts that the SEC could use to establish a violation of the federal securities laws. DPAs should not exceed five years. If the individual or company complies with all obligations during the term of the agreement, the SEC will dismiss its enforcement action and

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23. Press Release, SEC, SEC Announces Initiative to Encourage Individuals and Companies to Cooperate and Assist in Investigations (Jan. 13, 2010), www.sec.gov/news/press/2010/2010-6.htm.

24.–25. [Reserved.]

not pursue any further action regarding the matter in the agreement. Conversely, if the individual or company violates the agreement during its term, the SEC may pursue its enforcement action against the individual or company.

Non-Prosecution Agreements (NPAs). A non-prosecution agreement is a written agreement between the SEC and a potential cooperating individual or company under which the SEC agrees not to file an enforcement action against that individual or company if the individual or company agrees to cooperate fully and abide by certain terms. If the agreement is violated, the SEC may recommend an enforcement action against the individual or company.

These three tools, among others, are detailed in the "Fostering Cooperation" section of the SEC's Enforcement Manual. Additional tools, familiar to practitioners in criminal enforcement, include proffer agreements and immunity requests.[26] The end product of an internal investigation will very likely be one of these kinds of agreements, and the quality of the investigation may determine which kind and how favorable it is to the company. In the following sections we provide examples of the SEC's use of these tools.

[C] SEC's Use of DPAs and NPAs

On January 22, 2015, the SEC entered into a Deferred Prosecution Agreement (DPA) with PBSJ Corporation, an engineering and construction firm based in Tampa, Florida.[27] In 2009, a PBSJ officer violated the Foreign Corrupt Practices Act (FCPA) by offering and authorizing bribes to a foreign official to secure government contracts from the Qatari government. In exchange for the bribes, the Qatari official provided the officer with confidential bid and pricing information, which enabled an international subsidiary to win bids for a hotel resort development project in Morocco and a light rail project in Qatar.[28]

The SEC credited PBSJ for quickly investigating and self-reporting the misconduct and subsequently reviewing its compliance program. Pursuant to the DPA, PBSJ agreed to pay disgorgement and interest of $3,032,875 and a penalty of $375,000. This sum reflected the fact that PBSJ "cooperated substantially" with the SEC investigation, which included voluntarily producing documents and information related to the investigation, providing relevant witnesses for interview, and

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26. *See* SECURITIES AND EXCHANGE COMMISSION, DIVISION OF ENFORCEMENT, ENFORCEMENT MANUAL, OFFICE OF THE CHIEF COUNSEL (June 4, 2015) [hereinafter SEC ENFORCEMENT MANUAL], § 6.
27. Press Release, SEC, SEC Charges Former Executive at Tampa-Based Engineering Firm With FCPA Violations (Jan. 22, 2015), https://www.sec.gov/news/pressrelease/2015-13.html.
28. *Id.*

handing over factual chronologies, timelines, internal interview summaries, and other data.[29]

On December 20, 2010, the SEC announced that it had entered into a Non-Prosecution Agreement with Carter's Inc. in its first use of an NPA with a corporate putative defendant following the SEC's announcement of the "Cooperation Initiative" in January 2010. On the same day, the SEC announced charges against former Carter's Inc. Executive Vice President of Children's Clothing, Joseph M. Elles, for financial fraud and insider trading. From 2004 until 2009, Elles is alleged to have manipulated the dollar amount of discounts Carter's gave to its largest wholesale customer. Elles is claimed to have created and signed false documents misrepresenting the timing and amount of the discounts, which he submitted to Carter's accounting department. This resulted in understatements of expenses and overstatements of net income over the course several financial reporting periods. The SEC alleged that Elles also engaged in insider trading of shares of Carter's common stock during the fraud, which resulted in sizeable personal gains for Elles.

The SEC's decision to enter into an NPA with Carter's reflects not only the isolated nature of the unlawful conduct; the decision to enter into an NPA also reflects Carter's prompt self-reporting of the misconduct to the SEC and extensive cooperation in the investigation, which included conducting a thorough internal investigation. Ultimately, the SEC determined that an NPA was appropriate because "Carter's did the right thing by promptly self-reporting the misconduct, taking thorough remedial action, and extensively cooperating with our investigation."[30] Under the terms of the NPA, Carter's agreed to cooperate fully in any further investigations conducted by the SEC. Following the Carter's resolution, the SEC has used NPAs in other enforcement matters involving corporate putative defendants, including Fannie Mae and Freddie Mac in 2011, which involved alleged securities fraud and misleading statements relating to subprime loans, and Ralph Lauren in 2013, which involved alleged FCPA violations.

§ 5:4.4 Waiver of Privilege and Work Product Protection

[A] Generally

The SEC has stated that "a party's decision to assert a legitimate claim of privilege will not negatively affect their claim to a credit for

29. *Id*.
30. Press Release, SEC, SEC Charges Former Carter's Executive with Fraud and Insider Trading (Dec. 20, 2011), www.sec.gov/news/press/2010/2010-252.htm.

cooperation."[31] This is similar to the current DOJ policy (discussed at *infra* section 5:5.2), but both can present difficulties in practice. The SEC Enforcement Manual makes clear that "if a party seeks cooperation credit for timely disclosure of relevant facts, the party must disclose all such facts within the party's knowledge."[32] The SEC's stated policy and its actual practice make clear that it expects prompt and complete disclosure of all "relevant facts" regardless of how they were learned by the company or its counsel.

The SEC Enforcement Manual, for example, declares that "[t]o receive cooperation credit for providing factual information obtained from the interviews, the corporation need not necessarily produce, and the staff may not request without approval, protected notes or memoranda generated by the attorneys' interviews. [But t]o earn such credit, . . . the corporation does need to produce, and the staff always may request, relevant factual information—including relevant factual information acquired through those interviews."[33]

Thus, from the very outset of an investigation, the company, and the counsel conducting interviews and reviewing documents and other evidence, should be aware of the SEC's policy, and assume that any and all facts—however discovered—may be required to be disclosed if the company is to reap a benefit from its investigation. There may also be circumstances in which a company may receive a benefit from disclosing the substantive advice of counsel even though it is protected by privilege; but any such disclosure should be very carefully weighed against the downsides, including the possibility of subject-matter waiver. In walking the fine line between cooperation and the potential waiver of privilege—which can have devastating consequences in collateral proceedings such as derivative complaints or class action securities suits—the assistance of outside counsel well versed in these areas is essential.

[B] Confidentiality Agreements and Collateral Proceedings

As alluded to above, in an internal investigation of any significance—particularly if a restatement or an admission of wrongdoing is possible—companies should be alert to the possibility that collateral private proceedings, such as class actions or derivative suits, may seek to obtain and use information disclosed to the SEC.

If a company believes waiving its attorney-client privilege or its work product protection as to the SEC is in its interests, it may seek a

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31. *See* SEC ENFORCEMENT MANUAL, *supra* note 26, § 4.3.
32. *Id.*
33. *Id.*

confidentiality agreement with the SEC in which the Division would "agree[ ] not to assert that the entity has waived any privileges or attorney work-product protection by producing the documents . . . [and] also agree[ ] to maintain the confidentiality of the materials."[34]

Any confidentiality agreement would come with the important exception that the SEC may disclose the information "to the extent that the staff determines that disclosure is required by law or that disclosure would be in furtherance of the SEC's discharge of its duties and responsibilities." Although this language is not comforting, in many cases it will be the best compromise solution available.

It is very important, however, to review the case law regarding voluntary disclosure and partial waiver. A full review of the case law regarding the effect of voluntary disclosure on the attorney-client and work product privileges is beyond the scope of this chapter, but with very few exceptions the circuits have adhered to the traditional view that the intentional disclosure of a privileged document to any outside entity destroys the protections of the privilege against all others.[35] At least three circuits have held that the disclosure of privileged information pursuant to a confidentiality agreement destroys the privilege.[36]

§ 5:4.5 The Benefits of a Robust Internal Investigation

As we noted at the beginning of this chapter, although there are many business reasons a corporation might conduct an internal investigation, the principal reason for doing so is generally to satisfy the interest of some regulator. Recent SEC settlements indicate that the SEC is serious about rewarding cooperation, and illustrate the role an internal investigation can play in demonstrating that cooperation.

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34. *Id.* § 4.3.1.

35. The Eighth Circuit has permitted the limited waiver of attorney-client privilege (Diversified Indus. v. Meredith, 572 F.2d 596, 611 (8th Cir. 1977) (en banc)) and the Fourth Circuit has recognized limited waiver of work product protection (*In re* Martin Marietta Corp., 856 F.2d 619, 623–24 (4th Cir. 1988)). The aggressive posture of the DOJ does not appear to have caused the circuits to revisit the concept of limited waiver.

36. *See In re* Qwest Commc'ns Int'l Inc. Sec. Litig., 450 F.3d 1179, 1194 (10th Cir. 2006) (dismissing the notion that confidentiality agreements with enforcement agencies warrant the selective waiver rule under the circumstances presented); *In re* Columbia/HCA Healthcare Corp. Billing Prac. Litig., 293 F.3d 289, 307 (6th Cir. 2002) (rejecting the notion of selective waiver under the circumstances, notwithstanding the existence of a confidentiality agreement); *In re* Chrysler Motors Corp. Overnight Evaluation Program Litig., 860 F.2d 844, 847 (8th Cir. 1988) (holding that an agreement with one's adversary not to disclose work product materials to a third party could not protect the materials from waiver).

§ 5:5 Department of Justice Guidance Relating to Internal Investigations

§ 5:5.1 *Generally*

The DOJ has the formidable power to indict individuals and business organizations. The consequences of indictment can be disastrous. Once the DOJ gets involved, the goal is to persuade it that no criminal activity has occurred for which the corporation can be liable. If that is not possible, the secondary goal is two-fold: (1) to demonstrate by cooperation and remediation that one of the settlement devices (discussed below) is more appropriate than formal prosecution and (2) to persuade the DOJ that the appointment of an independent corporate monitor is not warranted.

The best way to achieve these objectives is often to conduct a prompt and thorough internal investigation, keeping in mind the various written guidance the DOJ has issued over the last decade.

To maximize the chances that the DOJ will stay its hand, a company must understand the DOJ's rules, guidance, and discretion, and proactively conduct a thorough internal investigation *before* the DOJ gets involved. Remedial efforts commenced after a DOJ investigation begins are generally less persuasive. This section addresses the sources of DOJ guidance and the factors a prosecutor will consider when evaluating a company's self-reporting and remediation efforts.

§ 5:5.2 *The Filip Memorandum*

On August 28, 2008, the DOJ issued the Filip Memorandum, the latest iteration of its charging guidelines, replacing the McNulty Memorandum, which had, in turn, superseded the Thompson Memorandum.[37] Unlike its predecessors, however, the principles articulated in the Filip Memorandum are binding on federal prosecutors because the guidelines have now been incorporated into the *United States Attorneys' Manual*.[38]

The value of an internal investigation in persuading a prosecutor that the company has adequately "cooperated" cannot be overstated. The nine factors that federal prosecutors must consider under the

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37. *See* Memorandum from Mark Filip, Deputy Attorney General, Principles of Federal Prosecution of Business Organizations (Aug. 28, 2008) [hereinafter Filip Memorandum], www.justice.gov/dag/readingroom/dag-memo-08282008.pdf; *see infra* Appendix C.

38. *See id.* at 1 ("The revised Principles will be set forth for the first time in the *United States Attorneys' Manual*, and will be binding on all federal prosecutors within the Department of Justice."). DEP'T OF JUSTICE, U.S. ATTORNEYS' MANUAL [hereinafter USAM], tit. 9, ch. 9-28.000, www.justice.gov/usao/eousa/foia_reading_room/usam/title9/28mcrm.htm.

Filip Memorandum in deciding whether to bring charges against a corporation are:

1. the nature and seriousness of the offense;
2. the pervasiveness of the wrongdoing within the corporation;
3. the corporation's history of similar conduct;
4. the corporation's timely and voluntary disclosure of wrongdoing and its willingness to cooperate in the investigation of its agents;
5. the existence and effectiveness of the corporation's pre-existing compliance program;
6. the corporation's remedial actions;
7. collateral consequences of prosecution;
8. the adequacy of the prosecution of individuals responsible for the corporation's malfeasance; and
9. the adequacy of remedies such as civil or regulatory enforcement actions.[39]

The fourth factor—"the corporation's timely and voluntary disclosure of wrongdoing and its willingness to cooperate in the investigation of its agents"—assumes that a company will conduct a prompt and thorough internal investigation and disclose its results. Indeed, the Filip Memorandum expressly contemplates that a company will gather "facts through an internal investigation."[40] Conducting such an investigation and disclosing its results allows the government to piggyback on a company's efforts in locating potentially relevant actors and evidence within the company. The fruits of such an investigation are particularly valuable to the DOJ where evidence exists overseas.

An internal investigation is also critical to addressing the first and second factors—"the nature and seriousness of the offense" and "the pervasiveness of the wrongdoing within the corporation." It is usually far better for a company to learn the relevant facts sooner, through an internal investigation, rather than later as a result of a government investigation.

The results of an internal investigation are often indispensible if the company is to address the fifth and sixth factors—"the existence and adequacy of the corporation's compliance program" and "the corporation's remedial actions." Under the Filip Memorandum, the kinds of remedial actions federal prosecutors consider include "disciplining

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39. *See* USAM § 9-28.300.
40. *See* USAM § 9-28.720(a).

wrongdoers," "efforts to pay restitution," and "recognition of the flaws in [a company's compliance] program and its efforts to improve the program."[41] Once the relevant facts are unearthed through an internal investigation, a company will be in a much better position to implement such remedial measures even before the DOJ knocks on the company's door.

Ultimately, an internal investigation will provide a company with the critical information it needs to evaluate suspected wrongdoing and the steps that must be taken to remediate and, possibly, self-report that wrongdoing. Once the company is in possession of all the facts, the question then becomes whether to share the facts with the DOJ and SEC. If the answer to that question is yes, then a company must determine what information to disclose, and when, in order to maximize the likelihood of obtaining credit for cooperating.

§ 5:5.3 The DOJ and the SEC Resource Guide to the FCPA

On November 14, 2012, the DOJ and the SEC jointly released *A Resource Guide to the U.S. Foreign Corrupt Practices Act* (the "Guide").[42] The Guide is a comprehensive overview of the agencies' FCPA enforcement approach and priorities. It sets forth factors prosecutors and SEC attorneys consider in determining whether to bring an enforcement action under the FCPA, largely echoing principles outlined in prior guidance. The Guide, however, provides valuable insights outside the FCPA context. The Guide emphasizes that "both DOJ and SEC place a high premium on self-reporting, along with cooperation and remedial efforts, in determining the appropriate resolution of FCPA matters."[43]

In addition to these factors, the Guide makes clear that DOJ and SEC consider the adequacy of a company's compliance program in determining the appropriate response to an FCPA violation.[44] The Guide identifies the hallmarks of strong compliance programs, while acknowledging that "there is no one-size-fits-all program."[45] The following are considered features of effective compliance programs:

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41. *See* USAM § 9-28.900.
42. *See* A RESOURCE GUIDE TO THE U.S. FOREIGN CORRUPT PRACTICES ACT BY THE CRIMINAL DIVISION OF THE U.S. DEPARTMENT OF JUSTICE AND THE ENFORCEMENT DIVISION OF THE U.S. SECURITIES AND EXCHANGE COMMISSION (Nov. 14, 2012), www.justice.gov/criminal/fraud/fcpa/guidance/guide.pdf.
43. *Id.* at 54.
44. *Id.* at 56.
45. *Id.* at 57.

- Commitment from senior management to a "culture of compliance" and a clearly articulated policy against corruption;
- A code of conduct that is "clear, concise, and accessible to all employees and to those conducting business on the company's behalf";
- An autonomous reporting structure bearing responsibility for oversight and implementation of the compliance program;
- Appropriate assessment of risk and proportional devotion of compliance resources;
- Positive incentives for corporate compliance and appropriate disciplinary measures;
- Adequate due diligence in transactions with third parties;
- Mechanisms for confidential reporting of potential violations within the company; and
- Continuous development of the compliance program.[46]

The Guide makes clear the government's commitment to providing favorable treatment to organizations that self-report and cooperate with authorities when problems arise. To illustrate this approach, the Guide offers six examples of instances in which DOJ or SEC declined to take enforcement action against a company. The Guide highlights features of the companies' responses to the misconduct that were influential in the decision not to prosecute, including: detection of the misconduct by the company's own internal controls; a thorough investigation of wrongdoing; disciplinary measures taken against the employees involved; prompt and voluntary reporting of the misconduct to the appropriate authorities; and immediate and substantial steps to improve compliance within the company.[47]

With respect to the importance of internal compliance processes, controls, and training, the DOJ and SEC enforcement action against a former Morgan Stanley managing director is instructive. In 2012, a former Morgan Stanley managing director pleaded guilty to conspiring to evade internal accounting controls Morgan Stanley maintained in order to comply with the FCPA, and at the same time settled a related SEC action. The DOJ and SEC took no action against Morgan Stanley. In announcing the resolution, the DOJ lauded Morgan Stanley's compliance program.[48] For example, the DOJ noted that between 2002

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46. *Id*. at 57–62.
47. *Id*. at 77–79.
48. *See* Press Release, DOJ, Former Morgan Stanley Managing Director Pleads Guilty for Role in Evading Internal Controls Required by FCPA

and 2008, Morgan Stanley trained various groups of Asia-based personnel on anti-corruption policies fifty-four times. The DOJ also noted that Morgan Stanley's compliance personnel regularly monitored transactions, conducted random audits of particular employees, transactions, and business units, and performed transaction testing to identify illicit payments. The press release also noted that Morgan Stanley conducted extensive due diligence on all new third-party business partners and imposed tight controls on third-party payments.

§ 5:5.4 DOJ's Corporate Compliance Counsel

In recent years, the DOJ has also increased its focus on ensuring that companies have robust and effective compliance programs. On November 3, 2015, the DOJ's Fraud Section announced that it had retained Hui Chen as Corporate Compliance Counsel. Chen's mission is to assist prosecutions in assessing a company's compliance program, "as well as [to] test the validity of [the company's] claims about its program, such as whether the compliance program truly is thoughtfully designed and sufficiently resourced to address the company's compliance risks, or essentially window dressing."[48.1]

Thus, during a DOJ investigation, a company's compliance program will be scrutinized in "real time" and this review will have a direct impact on the resolution of the investigation. Whereas companies had in the past typically met with prosecutors and presented their own assessment of their individual programs, those self-assessments are now scrutinized by the Compliance Counsel and the assessment carries significant weight with respect to the DOJ's decision regarding the appropriate resolution.[48.2]

In February 2017, the Compliance Counsel published a paper titled "Evaluation of Corporate Compliance Programs."[48.3] While stressing that "the Fraud Section does not use any rigid formula to assess the effectiveness of corporate compliance programs" the document provides "common questions that [DOJ] may ask in making an individualized determination" of a company's compliance program.[48.4] For

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(Apr. 25, 2012), www.justice.gov/opa/pr/former-morgan-stanley-managing-director-pleads-guilty-role-evading-internal-controls-required.

48.1. J. Gregory Deis, *US Department of Justice Intensifies Its Focus on Corporate Compliance*, Mayer Brown Legal Update (Dec. 8, 2015), https://www.mayerbrown.com/en-US/US-Department-Of-Justice-Intensifies-Its-Focus-on-Corporate-Compliance-Programs-12-08-2015/.

48.2. *Id.*

48.3. U.S. Dep't of Justice, Criminal Division, Fraud Section, Evaluation of Corporate Compliance Programs, https://www.justice.gov/criminal-fraud/page/file/937501/download.

48.4. *Id.*

example, DOJ included the following questions: "What is the company's root cause analysis of the misconduct at issue? What systemic issues were identified?" Obviously in order to answer these questions, a company will have had to have conducted an internal investigation. The DOJ will not look favorably on an offender company who has not engaged in that type of self-analysis and appropriate remediation.

§ 5:5.5 Information Relevant to Earning Cooperation Credit

[A] Generally

Like its predecessor, the Filip Memorandum divides information that may be uncovered by counsel in an internal investigation into two categories: (1) relevant facts concerning the putative misconduct, whether or not these facts are privileged communications or protected work product, and (2) non-factual (or "core") attorney-client communications or work product.[49] The expectation is that a corporation will fully disclose any and all "relevant facts," however they may have been discovered, but that no penalty will attach to withholding "core" privileged material.

[B] "Relevant Facts"

Under previous guidance (first the Thompson Memorandum, then the McNulty Memorandum), if a company wanted cooperation credit, there was strong pressure to waive privilege and disclose very broadly all the results of any investigation conducted by inside or outside counsel. This expectation resulted in a great deal of resistance from the business community and defense bar. In response, the Filip Memorandum decoupled the corporate decision to cooperate from the waiver of the attorney-client privilege and work product protection:

> In short, so long as the corporation timely discloses relevant facts about the putative misconduct, the corporation may receive due credit for such cooperation, regardless of whether it chooses to waive privilege or work product protection in the process. Likewise, a corporation that does not disclose the relevant facts about the alleged misconduct—for whatever reason—typically should not be entitled to receive credit for cooperation.[50]

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49. *See* USAM § 9-28.720(a) & (b). Although the most recent guidance alters the terminology of the McNulty Memorandum, the basic scheme remains the same. What the Filip Memorandum terms "relevant facts" is largely what was Category I information under the previous guidance, and "core" communications or "work product" is largely what was termed Category II information.

50. *See* USAM § 9-28.720(a).

The result of this guidance is twofold. First, the investigation should be conducted by experienced counsel familiar with the DOJ's guidance and mindful that the facts uncovered during their investigation may well be disclosed to the government. A careful plan of investigation is essential to ferret out all the relevant facts and enable the company to communicate these facts to the government, while preserving, to the maximum extent possible, the company's work product, privilege, and interest in confidentiality. This is often done through an oral proffer to the government, without turning over privileged materials or work product. The assistance of experienced counsel is essential in walking this fine line.

Second, corporate leadership must understand that prosecutors expect full disclosure of the relevant facts, if the company expects favorable treatment in return. Although this may be unsettling, it is often better than the alternative: an adversarial relationship with the DOJ, which, after all, has broad powers to investigate on its own. The company always has the option to say no to the DOJ, and take its lumps—but it is best to know what those lumps might look like before making that choice.

[C] "Core" Privileged Information

The Filip Memorandum increases the protection of "core" or non-factual privileged information and work product. Under the prior guidance, "if the purely factual information provided an incomplete basis to conduct a thorough investigation," prosecutors could request that a corporation provide non-factual attorney-client communications and work product.[51]

The Filip Memorandum prohibits prosecutors from requesting such waiver of any "core" attorney-client communications or work product.[52] And, importantly, the DOJ may not condition cooperation credit upon the waiver of privilege.[53] While companies are still free to voluntarily waive privilege, the Filip Memorandum alleviates the pressure to waive privilege and preserves the corporation's important interest in seeking and receiving legal advice without the concern that it will be disclosed.

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51. *See* Filip Memorandum at 10.
52. *See* Filip Memorandum, *supra* note 37, § 9-28.710 ("[W]hile a corporation remains free to convey non-factual or 'core' attorney-client communications or work product—if and only if the corporation voluntarily chooses to do so—prosecutors should not ask for such waivers and are directed not to do so.").
53. *See id.* § 9-28.720(b) ("A corporation need not disclose, and prosecutors may not request, the disclosure of . . . attorney work product as a condition for the corporation's eligibility to receive cooperation credit.").

§ 5:5.6 The Yates Memorandum

When conducting an internal investigation, companies must be increasingly proactive in investigating and reporting misconduct by individual employees. In September 2015, Deputy Attorney General Sally Yates issued a memorandum discussing the bases for cooperation credit in corporate fraud cases. Responding to wide-ranging criticism that the DOJ had not prosecuted executives who were responsible for the financial crisis, the Yates Memo states DOJ policy requiring that corporations disclose "all relevant facts" related to individuals responsible for misconduct, regardless of rank or seniority level, to qualify for cooperation credit.[54]

Many commentators have noted that the Yates Memo is not a sea change in DOJ procedure, but instead a refocusing on existing policy.[55] Nevertheless, the DOJ's renewed focus on prosecuting individuals should prompt companies to review mechanisms for reporting employees who have engaged in potentially illegal conduct. In addition, companies must be increasingly sensitive that its interests and those of its employees may diverge substantially over the course of an investigation. Companies should be sensitive to the potential need for employees to retain independent counsel at an earlier stage of the investigation process.[56]

§ 5:5.7 Deferred and Non-Prosecution Agreements in Criminal Actions

[A] Generally

The ultimate purpose of conducting an investigation is to persuade the DOJ that, in considering the nine factors described above in section 5:5.2, the company has fully cooperated, disclosed its wrongdoing, and remediated any problems it discovered. If successful, the government may refrain from taking any action against the company itself (though individuals may be less fortunate). But even if the government is not persuaded to take no action against the company,

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54. *See* Elizabeth E. Joh & Thomas W. Joo, *The Corporation as Snitch: The New DOJ Guidelines on Prosecuting White Collar Crime*, 101 VA. L. REV. ONLINE 51 (October 2015), www.virginialawreview.org/sites/virginialawreview.org/files/Joh%26Joo_Book.pdf.
55. *See, e.g.*, Daniel P. Chung, *Individual Accountability for Corporate Wrongdoing*, HARV. L. SCH. F. ON CORP. GOVERNANCE AND FIN. REG. (Sept. 21, 2015), http://corpgov.law.harvard.edu/2015/09/21/individual-accountability-for-corporate-wrongdoing.
56. Joh and Joo, *supra* note 54.
57.–58. [Reserved.]

there are steps short of criminal indictment and conviction that the government can take.

The DOJ has been making increased use of DPAs and NPAs since the early 2000s.[59] In a typical DPA, the government files criminal charges against the corporation, and the corporation accepts and acknowledges responsibility for the alleged unlawful conduct. Based on the corporation's acceptance of responsibility, and as long as the corporation complies with all of the obligations set forth in the DPA—which can include the payment of fines and penalties, extensive cooperation with the DOJ's investigation, appointment of an independent monitor, and establishment of internal compliance programs—the DOJ will defer prosecution for a period of time (often between one and three years). If the corporation complies with its obligation under the DPA, the charges are dismissed with prejudice at the end of the deferral period.[60]

A typical NPA imposes similar obligations on the corporation and places the corporation in a similar probationary period; if the corporation fails to comply with the obligations of the NPA, it can be prosecuted.[61] The NPA's principal advantage over a DPA is that no formal charges are brought.

An effective internal investigation, which may lead the company to engage in "voluntary" disclosures and remediation, can have an

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59. *See, e.g.*, Laurie P. Cohen, *Deferred Deals Like Quattrone's Are on the Rise*, WALL ST. J., Aug. 24, 2006, at C1 (reporting that prosecutors entered into twenty-three DPAs and NPAs with major U.S. companies between 2002 and 2005, compared with eleven such agreements between 1992 and 2001). The DOJ's increased use of these agreements also follows the very public June 2002 demise of Arthur Andersen LLP, which was convicted of obstruction of justice for its destruction of documents relating to its audit of Enron. Among the many notable aspects of the Andersen investigation, indictment, and subsequent trial was Andersen's failure to reach agreement with the DOJ on the terms of a DPA that could have averted the trial.

60. *See, e.g.*, ABN AMRO Deferred Prosecution Agreement (on file with authors); U.S. Notice of Filing Deferred Prosecution Agreement Between the U.S. Attorney's Office for the Middle District of Florida, the Florida Attorney General's Office, and Wellcare Health Plans, Inc., and its Affiliates and Subsidiaries, United States v. Wellcare Health Plans, Inc., 8:09-cr-00203, ¶¶ 10–14 (M.D. Fla. May 5, 2009), https://www.sec.gov/Archives/edgar/data/1279363/000110465909029512/a09-12598_1ex10d1.htm [hereinafter Wellcare Health Plans, Inc. Deferred Prosecution Agreement].

61. *See, e.g.*, Letter from Paul E. Pelletier, Acting Chief, Fraud Section, to Ronald L. Olson, ¶ 15 (Jan. 19, 2010) [hereinafter General Reinsurance Corporation Non-Prosecution Agreement], https://www.justice.gov/criminal-fraud/file/834836/download.

important—possibly an essential—role in avoiding criminal indictment through these mechanisms. (As discussed above in section 5:4.3[B], the SEC now uses very similar cooperation tools.) We discuss below several notable cases in which an effective internal investigation helped persuade the government that a DPA or NPA was an appropriate remedy. Below we discuss some recent examples of the DOJ's use of these tools.

[B] Deutsche Bank AG

On August 23, 2015, Deutsche Bank AG entered into a DPA with the DOJ relating to charges that it manipulated the U.S. Dollar London Interbank Offer Rate (LIBOR) and engaged in a scheme to fix Yen LIBOR in violation of the Sherman Act.[62] LIBOR is a benchmark rate meant to reflect the short term funding costs of major banks active in London. It is calculated daily by polling a panel of representative banks that submit LIBOR estimates.[63] Deutsche Bank also pled guilty to other LIBOR-related charges.[64]

Deutsche Bank admitted that it played a role in manipulating LIBOR by allowing the bank's derivatives traders to submit LIBOR estimates benefitting their trading positions. Pursuant to the DPA, Deutsche Bank must cooperate with the DOJ in its ongoing investigation, pay $650 million in penalties, and submit to a corporate monitor for three years. The DOJ estimates that the bank and its U.K. subsidiary will pay $775 million in criminal penalties. In entering into a DPA, the Justice Department took into consideration the bank's cooperation with government investigators, which, while helpful, "fell short in some important respects." In particular, Deutsche Bank was slow to cooperate with the DOJ investigation, was not proactive in its investigation and disclosure as compared to peer institutions, and its investigation was hampered by "numerous unintentional but significant mistakes in the preservation, collection, and production of documents, audio, and data." For example, the bank destroyed several thousand hours of audio recordings due to negligent execution of discovery holds.[65] On the other hand, the Justice Department considered

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62. Press Release, DOJ, Deutsche Bank's London Subsidiary Agrees to Plead Guilty in Connection with Long-Running Manipulation of LIBOR (April 23, 2015), https://www.justice.gov/opa/pr/deutsche-banks-london-subsidiary-agrees-plead-guilty-connection-long-running-manipulation.
63. ICE Benchmark Administration, LIBOR: Frequently Asked Questions, https://www.theice.com/publicdocs/IBA_LIBOR_FAQ.pdf.
64. Press Release, DOJ, Deutsche Bank's London Subsidiary Agrees to Plead Guilty in Connection with Long-Running Manipulation of LIBOR (April 23, 2015), https://www.justice.gov/opa/pr/deutsche-banks-london-subsidiary-agrees-plead-guilty-connection-long-running-manipulation.
65. Deutsche Bank AG Deferred Prosecution Agreement, ¶ 4.

extensive remedial measures and an enhanced compliance program put into effect by Deutsche Bank's management.

[C] Lending Processing Services Inc.

On February 15, 2013, the DOJ and mortgage servicing company Lender Processing Services Inc. (LPS) entered into an NPA relating to fraud perpetrated by DocX LLC, a fully owned subsidiary.[66] The settlement followed a guilty plea by DocX CEO Lorraine Brown admitting her role in a six-year scheme to prepare and file over one million fraudulently signed and notarized mortgage-related documents throughout the United States. Subsequently, LPS agreed to pay $35 million in criminal penalties and forfeiture.

Despite the significant fine, the NPA shows the benefits of conducting prompt investigations and cooperating fully with the government. In the NPA, the DOJ credited LPS with conducting a thorough internal investigation soon after discovering Brown and DocX's misconduct. In addition, it lauded LPS for promptly reporting its findings to the government, cooperating with the government investigation, and remedying all problems that it discovered, which included "important and positive changes in its compliance, training, and overall approach to ensuring its adherence to the law."[67] The agreement noted as a mitigating factor that Brown and DocX took active steps to conceal their fraud from LPS management and auditors.[68]

§ 5:5.8 Independent Corporate Monitors

[A] Generally

On March 7, 2008, the DOJ issued the Morford Memorandum, which provides guidance to federal prosecutors regarding the selection and use of independent corporate monitors in NPAs and DPAs.[69] A corporate monitor is an independent third party whose primary responsibility is to "assess and monitor a corporation's compliance with the

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66. Press Release, DOJ, Florida-Based Lender Processing Services Inc. to Pay $35 Million in Agreement to Resolve Criminal Fraud Violations Following Guilty Plea from Subsidiary CEO (Feb. 15, 2013), https://www.justice.gov/opa/pr/florida-based-lender-processing-services-inc-pay-35-million-agreement-resolve-criminal-fraud.
67. LPS Deferred Prosecution Agreement ¶¶ 1, 2.
68. *Id.* ¶ 4.
69. *See* Memorandum from Craig S. Morford, Acting Deputy Attorney General, Selection and Use of Monitors in Deferred Prosecution Agreements and Non-Prosecution Agreements with Corporations (Mar. 7, 2008) [hereinafter Morford Memorandum], www.justice.gov/dag/morford-useofmonitorsmemo-03072008.pdf.

terms of [its] agreement" with the DOJ.[70] The Morford Memorandum makes clear that the appointment of a corporate monitor is "not to further punitive goals."[71] Just as the number of NPAs and DPAs has increased, so too has the number of appointed monitors. According to a study conducted by the U.S. Government Accountability Office (GAO), twenty-six out of fifty-seven agreements reviewed by the GAO required the company to hire a monitor.[72]

Under the Morford Memorandum, federal prosecutors must balance two overarching considerations: (i) "the potential benefits that employing a monitor may have for the corporation and the public"; and (ii) "the cost of a monitor and its impact on the operations of a corporation."[73] In addition, the Morford Memorandum enumerates nine specific principles that should inform a federal prosecutor's selection and use of monitors:

- the DOJ and the corporation should agree on the monitor's "necessary qualifications," including choosing a monitor without any conflicts of interest, identifying respected and well-qualified individuals, and maintaining public confidence in the selection process;
- a monitor must be an independent third party;
- a monitor's primary responsibility should be to assess and monitor a corporation's compliance with those terms of the agreement that are specifically designed to address and reduce the risk of recurrence of the corporation's misconduct;
- a monitor's responsibilities should be no broader than necessary to address and reduce the risk of recurrence;
- a monitor may make periodic written reports to both the DOJ and the company;
- in evaluating whether the company has fulfilled its obligations under the agreement, the DOJ may consider whether a company chooses not to adopt the recommendations made by the monitor within a reasonable time;

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70. *Id.* at 2.
71. *Id.*
72. *See Corporate Crime: Preliminary Observations on DOJ's Use and Oversight of Deferred Prosecution and Non-Prosecution Agreements: Testimony Before the Subcomm. on Commercial and Administrative Law of the H. Comm. on the Judiciary*, 111th Cong. 19 (June 25, 2009) (statement of Eileen R. Larence, Director Homeland Security and Justice), www.gao.gov/new.items/d09636t.pdf.
73. Morford Memorandum, *supra* note 69, at 2.

- the agreement should clearly identify any types of previously undisclosed or new misconduct that the monitor will be required to report directly to the DOJ;
- the duration of the agreement should be tailored to the problems that have been found to exist and the types of remedial measures needed for the monitor to satisfy his or her mandate; and
- the agreement should provide for an extension or termination of the monitor at the discretion of the DOJ upon certain conditions.[74]

An internal investigation—especially one that identifies gaps in a company's compliance program and provides the basis for remedial measures—is critical to preempting the concerns underlying these factors and, thus, avoiding the appointment of a monitor altogether. Monitors are onerous in terms of time and cost—they are expensive, and they can be highly disruptive to normal business operations. Indeed, their presence can be highly intrusive, since they generally have full access to a company's books and records and are required to periodically report their findings to the DOJ. Companies generally find that they are better served by proactively investigating and remediating problems prior to reaching an agreement with the DOJ, and persuading the DOJ that a monitor is not required to ensure compliance.

§ 5:5.9 *Federal Sentencing Guidelines*

The Federal Sentencing Guidelines provide federal prosecutors with additional tools on which to rely when determining whether a corporation's self-investigation and self-reporting efforts are adequate.[75] Federal judges are required to consider these guidelines in the event of a criminal conviction (though they are not binding). Like the Filip Memorandum described above, the Sentencing Guidelines place significant emphasis on corporate cooperation and compliance programs in determining the penalties that corporations will face for violations of federal criminal laws.[76]

The section of the Guidelines devoted to the sentencing of organizations is intended to "offer incentives to organizations to reduce and

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74. *Id.* at 3–8.
75. The U.S. Sentencing Commission adopted the original set of Organizational Guidelines in 1991 (Chapter Eight of the Sentencing Guidelines). U.S.S.G. § 8A1.1 *et seq.* (1991). For a full discussion, see chapter 4.
76. *See* U.S.S.G. § 8B2.1 (2014).

ultimately eliminate criminal conduct by providing a structural foundation from which an organization may self-police its own conduct through an effective compliance and ethics program."[77] The section titled "Effective Compliance and Ethics Program" provides that, to have a compliance and ethics program that will factor favorably into a sentencing decision, an organization shall "[e]xercise due diligence to prevent and detect criminal conduct" and promote a culture that encourages ethical conduct and compliance with the law.[78] Section 8B2.1(b) identifies in detail the minimum requirements for an effective compliance program.

A defendant's "Culpability Score" (section 8C2.5) is used to decide whether to impose a fine on a corporation.[79] The section provides still another strong incentive for companies to develop effective compliance programs and self-report wrongdoing. For example, section 8C2.5(f) reduces the fine faced by a company that is found to have had an effective compliance and ethics program. Similarly, section 8C2.5(g) reduces the fine to be imposed upon a company that self-reports wrongdoing, cooperates fully in the investigation, and accepts responsibility for its sanctions. The application notes clarify that, to qualify for a reduction under section 8C2.5(g)(1) or (g)(2), cooperation must be timely and thorough.[80] Just as the Sentencing Guidelines reward effective compliance programs, self-reporting, and cooperation, they also punish a corporation that is found to have obstructed justice and impeded a government investigation.[81]

On April 29, 2010, the U.S. Sentencing Commission submitted amendments to Congress.[82] The amendments became effective on November 1, 2010.[83] There is one amendment to the Organizational

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77. *Id.* § 8, Introductory Commentary.
78. *Id.* § 8B2.1.
79. *See id.* § 8C2.5.
80. *See id.* § 8C2.5 cmt. 12.
81. Effective November 1, 2006, the Sentencing Commission deleted from the application notes to section 8C2.5 the requirement that a company waive its attorney-client and work product privileges in order to achieve a culpability reduction under section 8C2.5(g) whenever waiver is deemed "necessary in order to provide timely and thorough disclosure of all pertinent information known to the organization."
82. *See* Amendments to the Sentencing Guidelines (May 3, 2010), www.ussc.gov/sites/default/files/pdf/amendment-process/reader-friendly-amendments/20100503_RFP_Amendments.pdf.
83. *See* Press Release, U.S.S.C., U.S. Sentencing Commission Votes to Send to Congress Guideline Amendments Providing More Alternatives to Incarceration, Increasing Consideration of Certain Specific Offender Characteristics During the Sentencing Process (Apr. 19, 2010), www.ussc.gov/about/news/press-releases/april-19-2010.

section of the Guidelines that is pertinent to the discussion in this chapter. The amendment adds an application note to the Commentary to section 8B2.1 (Effective Compliance and Ethics Program), clarifying the remediation efforts needed to satisfy the requirement of the organization to "take reasonable steps to respond appropriately to the criminal conduct and to prevent further similar criminal conduct, including making any necessary modifications to the organization's compliance and ethics program."[84] The new notes commenting on this requirement state:

> Application of Subsection (b)(7).—Subsection (b)(7) has two aspects.
>
> First, the organization should respond appropriately to the criminal conduct. The organization should take reasonable steps, as warranted under the circumstances, to remedy the harm resulting from the criminal conduct. These steps may include, where appropriate, providing restitution to identifiable victims, as well as other forms of remediation. Other reasonable steps to respond appropriately to the criminal conduct may include *self-reporting and cooperation with authorities.*
>
> Second, the organization should act appropriately to prevent further similar criminal conduct, including assessing the compliance and ethics program and making modifications necessary to ensure the program is effective. The steps taken should be consistent with subsections (b)(5) and (c) and may include the use of an outside professional advisor to ensure adequate assessment and implementation of any modifications.[85]

The commentary to subsection (b)(7) makes clear that self-reporting, cooperating, and making appropriate enhancements to compliance programs may be reasonable steps in responding appropriately to criminal conduct.

§ 5:6 FINRA Guidance As It Relates to Internal Investigations

§ 5:6.1 Generally

While the SEC may be the regulator that most frequently prompts a large-scale internal investigation, and the DOJ may wield the biggest stick, the SROs to which certain regulated companies (such as registered broker-dealers) must belong may exercise the most routine,

84. U.S.S.G. § 8B2.1(7) (2014).
85. *Id*. cmt. n.6 (emphasis added).

day-to-day supervisory authority over them. The self-reporting obligations with respect to SROs are considerable because, as member organizations, they take the view that members have consented to certain disclosure obligations, and are obliged, even in the absence of incentives, to investigate and self-report violations.

The structure of the FINRA regulatory scheme requires some explanation. In July 2007, New York Stock Exchange (NYSE) Regulation (the former investigation and enforcement arm of the NYSE) and the National Association of Securities Dealers (NASD) were combined to form FINRA.[86] FINRA was designed to provide a unitary member investigation and disciplinary authority, and to perform professional licensing, customer arbitration and other functions formerly performed by the NYSE and NASD separately. While this has simplified some aspects of the regulatory scheme, harmonizing the disciplinary rules of the NYSE and NASD has not proceeded very expeditiously.

In particular, no master FINRA rulebook has yet been produced. Instead, FINRA is proceeding piecemeal, proposing particular rules that supersede and harmonize former NYSE and NASD rules on an *ad hoc* basis. It is therefore important for issuers subject to FINRA authority to be aware of whether the former rules have yet been superseded, and, if so, whether there are any substantive differences. With respect to the old rules, FINRA has stated:

> The FINRA rulebook currently consists of both NASD Rules and certain NYSE Rules that FINRA has incorporated (Incorporated NYSE Rules) . . . In interpreting the rule sets, FINRA will continue to apply the same interpretive materials that NASD and NYSE applied prior to closing. For example, FINRA will consider existing NASD interpretive letters and Notices to Members in applying NASD Rules and the NYSE Rule Interpretations Handbook and Information Memos in applying the Incorporated NYSE Rules.[87]

Fortunately, with respect to "cooperation," FINRA has issued guidance (if not new rules) regarding "Credit for Extraordinary Cooperation."

§ 5:6.2 The Benefits of "Extraordinary Cooperation"

As mentioned above, the position of the SROs had always been that members are, as a matter of course, expected to cooperate fully with

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86. *See* Press Release, SEC, SEC Gives Regulatory Approval for NASD and NYSE Consolidation (July 26, 2007), www.sec.gov/news/press/2007/2007-151.htm.

87. *See* FINRA Rules Page, www.finra.org/RulesRegulation/FINRARules/index.htm.

investigation and enforcement proceedings. In a November 2008 release,[88] FINRA made clear that its position was no different:

> The cornerstone of the investigative and enforcement authority of self-regulatory organizations in the securities industry is the requirement that firms and individuals employed in the industry comply with regulatory requests for information or testimony. Notwithstanding this obligation, in certain situations, actions taken by firms or individuals go far beyond such compliance and rise to the level of extraordinary cooperation. Depending on the facts and circumstances, there are instances where cooperation by a firm or individual is so extraordinary that it should be taken into consideration in determining the appropriate regulatory response.

How would such "extraordinary cooperation" be rewarded? FINRA stated:

> Credit for extraordinary cooperation in FINRA matters may be reflected in a variety of ways, including a reduction in the fine imposed, eliminating the need for or otherwise limiting an undertaking, and including language in the settlement document and press release that notes the cooperation and its positive effect on the final settlement by FINRA Enforcement. In an unusual case, depending on the facts and circumstances involved, the level of extraordinary cooperation could lead FINRA to determine to take no disciplinary action at all.

These are tantalizing carrots. But what must a company do to be "extraordinary"?

§ 5:6.3 *What Is "Extraordinary Cooperation"?*

[A] Generally

The factors described by FINRA for "extraordinary cooperation" are not surprising, but they should be understood in light of the presumption that member companies are already required to provide extensive disclosure and cooperation, and FINRA's obligation to protect customers of its regulated entities. The four factors expressly identified by FINRA are:

- Self-Reporting of Violations;

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88. FINRA Regulatory Notice 08-70, FINRA Investigations: FINRA Provides Guidance Regarding Credit for Extraordinary Cooperation (Nov. 2008), www.finra.org/sites/default/files/NoticeDocument/p117452.pdf.

- Extraordinary Steps to Correct Deficient Procedures and Systems;
- Extraordinary Remediation to Customers; and
- Providing Substantial Assistance to FINRA Investigations.

None (except perhaps the third) should be surprising. Each is discussed below.

[B] Self-Reporting of Violations

Because there already is a duty to report violations of FINRA, NYSE, or NASD rules, in order to be considered extraordinary the self-reporting must be "prompt, detailed, complete and straightforward."[89]

Establishing the facts with sufficient certainty to make the determination of whether, when, how, and what to report is often something that can only be done after a thorough internal investigation. The emphasis on promptness suggests that the investigation should commence earlier rather than later, and FINRA is unlikely to look favorably on any signal that the company was reluctant to get to the bottom of whatever problem was discovered.

[C] Extraordinary Steps to Correct Deficient Procedures and Systems

In order for remedial actions to be considered extraordinary, they must be taken "early on, well before completion of FINRA's investigation."[90] Like the other regulators discussed above, FINRA expects not only that the company will take steps to prevent future rule violations, but that it has done so as soon as deficiencies in its internal supervision and controls are discovered.

[D] Extraordinary Remediation to Customers

In order for remediation to be extraordinary, the firm must "promptly and immediately identify[ ] injured customers and mak[e] such investors whole [or] proactively identif[y] and provide[ ] restitution to injured customers that goes beyond the universe of customers and transactions covered by the staff's investigation."[91] This factor is unusual, and reflects FINRA's focus on customer protection in light of its mission to regulate broker-dealers and other regulated persons and entities.

Care must be taken whenever customers are involved, or potentially involved, in a rules violation. If a corporation is lucky, it may be able to forestall customer arbitration in a FINRA forum. If not,

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89. *Id.*
90. *Id.*
91. *Id.*

and if the customer in question is not subject to arbitration, it may be facing a civil securities fraud suit. It should also be borne in mind that "customers" are not necessarily individuals, but may be institutional investors, other banks or similar regulated entities, or other sophisticated entities with the resources and the inclination to pursue extensive private remedies. These customers are just as entitled to the protection of FINRA rules as mom-and-pop investors.

[E] Providing Substantial Assistance to FINRA Investigations

"Substantial assistance" is the most vague of the criteria identified by FINRA. Fortunately, FINRA has suggested the following examples of "substantial assistance that may, depending on the circumstances, warrant credit":[92]

- Providing access to individuals or documents outside FINRA's jurisdiction that are critical to a full investigation of violative conduct.
- Upon learning of a problem, firms often undertake comprehensive internal investigations, and then brief FINRA staff on their findings. FINRA has credited these proactive undertakings by firms that greatly assisted the staff's investigations.
- Cooperation with FINRA to uncover substantial industry wrongdoing. When ongoing violative conduct has numerous participants yet is difficult to uncover, collaboration with the regulator can have a dramatic impact on regulatory consequences.

The second example most obviously impacts the decision to initiate an internal investigation, and is a powerful incentive in favor of a careful investigation managed by outside counsel, who will then be well positioned to make a credible report to FINRA regulators. "These steps alone or taken together can be viewed in a particular case as extraordinary cooperation and, depending on the facts and circumstances, can have an impact on FINRA's enforcement decisions."[93]

§ 5:7 State Investigations and Internal Investigations

It is impossible, within the scope of this chapter, to discuss the practices and policies of fifty different state attorneys general, and their various "blue sky" bureaus and laws. We will therefore offer only a brief discussion of one of the most powerful motivators to keeping a

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92. *Id.*
93. *Id.*

good relationship with state authorities in state securities practice—New York's Martin Act.

§ 5:7.1 The Martin Act

New York's Martin Act[94] is probably the most powerful of the state blue sky laws. Originally enacted in 1921, the Martin Act predates the Securities and Exchange Acts, and has been given a broad and powerful construction in the state courts. It was largely dormant until revived by former Attorney General Eliot Spitzer as a significant investigative tool.

Although it creates no private right of action, the Martin Act is remarkable for its substantive breadth; unlike a federal fraud claim, "to establish liability for fraudulent practices in an enforcement proceeding under the Martin Act, the Attorney-General need not allege or prove either *scienter* or intentional fraud."[95]

The dual nature of the act—which provides for both civil and criminal liability—means that every investigation contains the possibility of indictment, and the attorney general can decide at any point to seek criminal charges. The statute includes a provision for the criminal indictment of business organizations, both for misdemeanors,[96] and for felonies.[97] But for purposes of this discussion, it is particularly worth noting the attorney general's extremely broad subpoena and investigative powers.

§ 5:7.2 Martin Act Investigations

The Martin Act allows the attorney general to issue subpoenas for testimony and for documents, and makes a failure to respond a misdemeanor.[98] It also allows the attorney general to

> either require or permit [an investigated entity] or any agent or employee thereof, to file with him a statement in writing under oath or otherwise as to all the facts and circumstances concerning the subject matter which he believes it is to the public interest to investigate. . . . The attorney-general may also require such other data and information as he may deem relevant and may make such special and independent investigations as he may deem necessary in connection with the matter.[99]

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94. N.Y. GEN. BUS. LAW art. 23A.
95. State v. Rachmani Corp., 71 N.Y.2d 718, 725 n.6 (1988).
96. N.Y. GEN. BUS. LAW § 352-c(c)4.
97. N.Y. GEN. BUS. LAW § 352-c(c)5–6. Note that N.Y. PENAL LAW § 20.20 sets out general requirements for criminal liability of corporations.
98. N.Y. GEN. BUS. LAW § 352(4).
99. N.Y. GEN. BUS. LAW § 352(1).

In practice, Martin Act investigations have been handled in much the same way as DOJ and other investigations, with the end result being a civil action with a negotiated settlement at the conclusion of a lengthy investigation, during which the company and its counsel will have some opportunity to make a case that prosecution (or, at least, *criminal* prosecution) is not appropriate. In the event that a corporation becomes the subject of a Martin Act investigation, it is very important to quickly come to grips with its potential exposure, because there is no effective limit to the ability of the government to conduct an extensive investigation and to compel testimony.

§ 5:8 Conclusions—The Role of the Internal Investigation

As regulators have formalized and implemented the carrot-and-stick approach discussed above, it has become clear that prompt, thorough, and complete disclosures, coupled with effective remediation of any problems discovered, can mitigate the sanctions faced by a company. In order to evaluate the risks of cooperation versus non-cooperation, it is generally necessary to conduct an internal investigation, to develop complete understanding of the facts. Sometimes such an investigation is mandatory; as discussed above in section 5:3, some statutes require investigation. And Sarbanes-Oxley provides CEOs and CFOs with a powerful incentive to ensure that a company's internal controls are effective, and that there have been no misstatements in its books and records or its public filings. This can sometimes only be ascertained with a hard outside look.

Assuming it is not statutorily required, a company that becomes aware of possible wrongdoing faces a number of questions:

- How credible is the allegation or suggestion of wrongdoing?
- Should the investigation be conducted by inside or outside counsel?
- What is the best approach to investigating it?
- To what level of management should the concerns be elevated?
- Should the matter be referred to the audit committee?
- Should the audit committee engage independent counsel to investigate the matter?
- Do the facts discovered implicate any disclosure obligations?

The purpose of this chapter has been to describe the interests that will guide and inform these choices; you will find good answers to the more practical aspects of these questions—how you actually conduct an internal investigation—in the other chapters of this book.

Despite the tenor of this chapter, which—we feel, prudently—reflects an inclination toward investigation and, in some instances, disclosure, disclosure is not always the best route. If the conduct turns out to be trivial, the allegation frivolous, or the problem easily remediated, then it may be the case that no disclosure is warranted or recommended.

However, the only way to assess that question is to know the facts. A lack of knowledge constrains a company's options—it cannot proceed on an informed basis if it does not know what happened. Deciding not to disclose information once it is discovered may be a tough decision to make, but at least it is a choice between options, and at least the company will understand its possible exposure. Simply electing not to know is virtually never a good option in this regulatory environment.