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 of 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 the accuracy of the misconduct allegations and, if accurate, determine the extent of the misconduct and how to address it; (2) undertake remedial measures designed to guard against recurrences of the misconduct; (3) make an informed decision on whether to disclose the misconduct to the authorities; and (4) assist in any ensuing government investigation. These actions will allow the company to credibly argue that it has appropriately addressed the misconduct and therefore warrants lenient treatment from the authorities. Only a thorough internal investigation will provide a company with the facts it needs to respond effectively to the threat of a regulatory or criminal investigation.

Legislators, 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 vigorously investigate internal problems once discovered. The carrot is reserved for those that can demonstrate that they have forthrightly looked into any issues discovered, self-disclosed any violations 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 regulatory constituencies to which a company may be expected to report.¹

§ 5:2 The Constituencies for an Internal Investigation

A successful internal investigation can have many salutary business benefits—by improving internal controls and reporting lines, identifying potential trouble spots, and ferreting out untrustworthy employees. 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 the fruits of the internal investigation may be shared with the relevant regulator in order to persuade that 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 things 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 2002² ("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 purposes of an 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, or at least contemplated, before inside counsel receives a letter from the SEC announcing an informal 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 potentially 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

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¹. This chapter focuses on guidance offered by the SEC, DOJ, the Federal Sentencing Guidelines, FINRA, SOX, and New York State’s Martin Act.
². See infra section 5:3.2.
been raised considerably. Criminal sanctions as well as fines or civil penalties are now a possibility, and it is more important than ever to make a compelling case that the company had 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. For many such entities, investigatory and disciplinary Self-Regulatory Organization (SRO) functions are performed by 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 the 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, 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 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 or which are required to file reports under section 15[d] of the Exchange Act, or have a not-yet-effective registration under the Securities Act. That is, as a practical matter, it applies to all public


(Securities Investigations, Rel. #5, 8/15) 5–5
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 to section 10A of the Exchange Act certain requirements related to the powers and duties of public companies’ audit committees. This provision requires that public companies have an audit committee 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 often necessary to determine whether there has been any misconduct by a company employee and whether remediation, self-reporting, or even financial restatements are required.

The audit committee is charged with the oversight and 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. 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.

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5. 15 U.S.C. § 78j-1[m][5]–[6].
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 is often 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) 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 diligently investigate 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].

While a material weakness in the controls 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,

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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 Enters., 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.
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 internal investigations 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 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.\(^11\)

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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 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).
These requirements essentially require a company’s chief legal officer to initiate a formal investigation in response to any allegation of wrongdoing 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 protection extends not only to employees who provide information to the government in the context of a formal or informal investigation, but also to those who 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 $50 million to sixteen individuals.11.1 In 2014, the SEC paid $30 million to a whistleblower residing outside the United States, the largest award to date. Also 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.\footnote{12}

\section*{§ 5.4  SEC Guidance Relating to Internal Investigations}

For almost a decade, the SEC has issued occasional guidance as to 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.

\subsection*{§ 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—the first time that the SEC used a section 21(a) report in this manner.\footnote{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:

\begin{itemize}
\item \textbf{Voluntary Disclosures:}\ The SEC places significant emphasis on voluntary disclosures of securities violations that are not subject to mandatory reports.
\item \textbf{Timeliness:}\ The SEC generally prefers to receive information about securities violations as promptly as possible.
\item \textbf{Accuracy:}\ The SEC expects companies to provide accurate and complete information about securities violations.
\item \textbf{Cooperation:}\ The SEC values cooperation with its investigations, and looks favorably on companies that actively assist in its efforts.
\end{itemize}

• 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.  

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

14.  Id.
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.

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

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;

15. *Id.*
While SEC practitioners may not have been surprised by these criteria, the SEC’s willingness to disclose how it makes enforcement decisions was both welcome and noteworthy. 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.

§ 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.

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

16. Id.
18. [Reserved.]
19. [Reserved.]
20. [Reserved.]
revenue. Similarly, a monetary penalty would be appropriate if the issuer is in any other way “unjustly enriched.” 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 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

- 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.” 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.

22. [Reserved.]
[B] Cooperation of Individuals

One of the most complex aspects of managing an internal investigation is dealing with employees who may be the subject of adverse action by the company or the government. This is especially so when an employee is terminated and his or her interests have diverged from those of the company. The fact that the SEC has streamlined the procedures for obtaining approval for immunity agreements is not directly relevant to how an internal investigation is conducted, but it highlights the necessity for exercising care and obtaining sound legal advice when dealing with employees who may be implicated in malfeasance.

More directly relevant is that the SEC has provided guidance on how it will evaluate the cooperation of individuals. In its policy statement, the SEC has identified four general considerations:

- The nature of the assistance provided by the cooperating individual;
- The importance of the underlying matter in which the individual cooperated;
- The societal interest in ensuring the individual is held accountable for his or her misconduct; and
- The appropriateness of cooperation credit based upon the risk profile of the cooperating individual.  

The Cooperation Initiative is designed to obtain cooperation by individuals, and to obtain it quickly. A company must therefore consider very early in the investigative process how it intends to handle individual employees who may become the subject of an SEC inquiry. This includes the decision whether, and when, to recommend to employees that they obtain personal counsel. With the SEC’s increased emphasis on encouraging individual employees to cooperate, it is especially important for a company to quickly and thoroughly conduct an internal investigation, self-report, and take any necessary remedial action. The SEC should not hear evidence of wrongdoing from a cooperator first.

[C] Cooperation Tools

The three types of agreements that may be used to resolve enforcement matters appear to be 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 assert 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 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.

**[D] Tenaris**

On May 17, 2011, the SEC entered into a Deferred Prosecution Agreement (DPA) with Tenaris S.A. in the first use of a DPA since the SEC introduced the “Cooperation Initiative” in January 2010. The SEC alleged that Tenaris violated the Foreign Corrupt Practices Act (FCPA) by bribing government officials in Uzbekistan to secure several contracts to supply pipelines for transporting oil and natural gas.

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25. [Reserved.]
Tenaris made almost $5 million in profits from the contracts awarded by the Uzbekistan government, according to SEC allegations. Despite Tenaris’ alleged unlawful conduct, the SEC gave the company credit for “demonstrat[ing] high levels of corporate accountability and cooperation.” Tenaris notified the SEC after discovering the FCPA violations during an internal review. In response, Tenaris reviewed its controls and compliance measures, enhanced its anti-corruption policies and practices, and agreed to cooperate with the SEC and DOJ in connection with its case. SEC officials lauded the company, saying that “when Tenaris discovered the illegal conduct, it took noteworthy steps to address the violations and significantly enhanced its anti-corruption policies and practices to remediate weaknesses in its internal controls.”

Pursuant to the terms of the DPA, Tenaris agreed to pay $5.4 million in disgorgement and prejudgment interest. Tenaris also agreed to pay a $3.5 million criminal penalty as part of a Non-Prosecution Agreement with the DOJ. The SEC agreed to refrain from prosecuting Tenaris in a civil action if Tenaris complied with the conditions of the DPA, which included: (1) implementing due diligence requirements related to retention and payment of agents; (2) providing detailed training on the FCPA and other anti-corruption policies; (3) requiring certified compliance with anti-corruption policies; and (4) notifying the SEC of any complaints, charges, or convictions against Tenaris or its employees related to violations of any anti-bribery or securities law.

**[E] Carter’s Inc.**

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 since 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

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28. *Id.*
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.” Under the terms of the NPA, Carter’s agreed to cooperate fully in any further investigations conducted by the SEC.

[F] Smith & Nephew

In February 2012, the SEC charged Smith & Nephew PLC, a U.K.-based company, with violating the FCPA after discovering that its U.S. and German subsidiaries engaged in bribery of public doctors in Greece for over a decade. According to the SEC complaint, the Smith & Nephew subsidiaries essentially created offshore funds that were not subject to Greek taxes, which were used to bribe doctors to purchase Smith & Nephew products. These funds were recorded as payments for marketing services though no such services were performed.

In announcing the charges, the SEC noted that Smith & Nephew “failed to act on numerous red flags” when employees at both the company and its subsidiaries began to notice the illegal activity. Smith & Nephew agreed to pay more than $5.4 million to the SEC in disgorgement and pre-judgment interest without admitting or denying the charges. It is interesting to note that Smith & Nephew was able to enter into the agreement without admitting or denying the charges, while its subsidiary entered into a DPA just one month after the SEC announced its new “neither admit nor deny” policy.

The U.S. subsidiary, Smith & Nephew Inc., agreed to pay a $16.8 million penalty to the DOJ as part of a DPA. The DOJ noted

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31. Id.
32. Id.
33. Id.
34. Id.
Smith & Nephew’s cooperation with the DOJ investigation, and lauded the subsidiary’s self-investigation, remedial efforts, and compliance improvements.  

§ 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 cooperation.” 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.” 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.”

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 perceive a benefit to 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.

36. See SEC ENFORCEMENT MANUAL, supra note 24, § 4.3.
37. Id.
38. Id.
[B] Confidentiality Agreements and Collateral Proceedings

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 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.”

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.

At least three circuits have held that the disclosure of privileged information pursuant to a confidentiality agreement destroys the privilege.

39. Id. § 4.3.1.
40. 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.
41. 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).
§ 5:4.5 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.

[A] Aon Corp.

Aon Corp., one of the world’s largest insurance brokerage firms, entered into an NPA with the DOJ on December 20, 2011, to resolve charges that an Aon subsidiary violated the FCPA.42 Aon Limited, a U.K. subsidiary of Aon Corp., allegedly misused funds earmarked for training and education costs.43 Over the course of eight years, beginning in 1997 and extending through 2005, education and training funds were used to reimburse officials from the Instituto Nacional de Seguros, a Costa Rican state-owned insurance company, for international travel and other expenditures that could not be determined from Aon’s records and that clearly were unrelated to legitimate business purposes.44 Aon also admitted that it had failed to maintain adequate internal accounting controls that would have allowed the corporation to adequately comply with the FCPA.45

The DOJ agreed to settle the FCPA charges with Aon using an NPA based in part on Aon’s “extraordinary cooperation” with the DOJ and the SEC.46 The department lauded Aon for its complete and timely disclosure of the improper payments and its extensive remedial efforts—factors the department noted led to a “substantially reduced monetary penalty.”47 Pursuant to the NPA, Aon must continue to cooperate fully with the DOJ and to adhere to rigorous compliance, bookkeeping, and internal controls. Additionally, Aon agreed to pay $1.76 million to DOJ to resolve the FCPA violations.48

Without admitting or denying the charges in the SEC complaint, Aon reached an agreement with the SEC in a related matter, with Aon

43. Id.
44. Id.
45. Id.
46. Id.
47. Id.
48. Id.
agreeing to pay $14.5 million in disgorgement and prejudgment interest for the FCPA violations. The SEC’s complaint alleged that between 1983 and 2007, Aon subsidiaries made improper payments totaling more than $3.6 million to employees of foreign government-owned clients and third-party facilitators to obtain and maintain insurance contracts in a number of countries worldwide, including Costa Rica, Egypt, and Indonesia. The settlement was filed in the U.S. District Court for the District of Columbia on December 20, 2011.

[B] infoUSA Inc.

On March 15, 2010, the SEC settled charges with infoUSA Inc. (now known as “infoGroup Inc.”) stemming from allegations that infoUSA’s Forms 10-K and associated proxy statements for fiscal years 2003 through 2005 contained material understatements, misstatements, and omissions. More specifically, infoUSA allegedly materially understated the compensation paid to its former CEO and Chairman by $9,297,000. Based on its remedial efforts, however, infoUSA was only ordered to cease and desist from committing or causing any further federal securities law violations. Significantly, infoUSA did not have to pay any civil penalty.

In accepting infoUSA’s settlement offer, the SEC “considered remedial acts undertaken by infoUSA and cooperation afforded the [SEC] staff.” InfoUSA’s remedial action included: (i) replacing culpable officers and directors; (ii) creating a new position of executive vice president for business conduct and general counsel; (iii) instituting mandatory directory and executive officer training programs; (iv) hiring an independent compensation consultant to advise on compensation matters; and (v) implementing new internal control procedures and policies concerning reimbursement for expenses, perquisites, and related party transactions. Lastly, infoUSA formed a special litigation committee, which hired outside counsel to conduct an internal investigation, the results of which infoUSA presented to the SEC staff.

50. Id.
51. Id.
53. Id. at 4.
On April 1, 2010, the SEC and DOJ announced concurrent settlements with Daimler AG ("Daimler") based on allegations that Daimler violated the books and records provisions of the FCPA.\textsuperscript{54} This case can also be considered with respect to the DOJ guidance, which is discussed in \textit{infra} section 5:5.\textsuperscript{55} Daimler’s cooperation played a significant factor in its ability to avoid prosecution. The SEC and DOJ alleged that, over the course of ten years, Daimler and its subsidiaries paid tens of millions of dollars in bribes to foreign government officials in Asia, Africa, Eastern Europe, and the Middle East in order to further government sales.\textsuperscript{55} To conceal the misconduct, Daimler improperly recorded the transactions in its books and records. Through the illegal conduct, Daimler admitted that it had earned more than $50 million. In settling with the DOJ, Daimler agreed to pay a criminal penalty of $93.6 million, which is 20% below the bottom of the range advised by the sentencing guidelines. Daimler further agreed to engage an independent compliance monitor for three years.

In deciding to enter into a DPA with Daimler, the DOJ considered that Daimler: (i) voluntarily and timely disclosed the misconduct to the DOJ and the SEC; (ii) conducted an internal investigation; (iii) regularly reported its findings to the DOJ; (iv) cooperated with both the DOJ and SEC in their investigations; (v) undertook remedial measures, which included retaining an independent compliance advisor and implementing an enhanced compliance program; and (vi) agreed to continue to cooperate.\textsuperscript{56}

Two of Daimler’s subsidiaries pleaded guilty to FCPA offenses, but because of its extensive remedial efforts, the parent company was spared.\textsuperscript{57} In its sentencing memorandum, the DOJ noted Daimler’s cooperation:

\begin{quote}
The Department considers Daimler’s cooperation in this investigation to have been excellent. Specifically, Daimler conducted a worldwide internal investigation, involving dozens of countries and every major market in which the company does business. The
\end{quote}

\textsuperscript{54} See 15 U.S.C. §§ 78dd-1 \textit{et seq.}


company regularly presented its findings to the Department. In addition, Daimler made certain witnesses available to the Department, and voluntarily complied with requests for the production of documents from overseas.\textsuperscript{58}

[D] Ralph Lauren Corporation

On April 22, 2013, the SEC announced its first NPA involving FCPA misconduct with Ralph Lauren Corporation, a worldwide designer and distributor of premium apparel and accessories.\textsuperscript{66} The NPA alleged that an indirect, wholly owned Argentinian subsidiary of Ralph Lauren Corporation approved $568,000 in bribe payments to Argentine customs officials to facilitate the importation of goods into Argentina without inspection by customs officials. The Argentine subsidiary allegedly lacked sufficient internal controls to detect the misconduct. Ralph Lauren Corporation discovered the bribe payments when it implemented a new version of its compliance program. Within two weeks of uncovering the alleged bribes, Ralph Lauren Corporation reported the misconduct to the SEC and DOJ. The corporation also ceased operations in Argentina and further strengthened its compliance program.\textsuperscript{67}

The SEC agreed to enter into an NPA with Ralph Lauren Corporation based on the company’s “exceptional assistance” in the SEC’s investigation.\textsuperscript{68} The SEC praised the company’s voluntary and expeditious production of documents; its willingness to make overseas witnesses available for interviews; and its provision of interview summaries to SEC staff. The SEC stressed that its agreement with Ralph Lauren Corporation “makes clear that we will confer substantial


\textsuperscript{59} [Reserved.]

\textsuperscript{60} [Reserved.]

\textsuperscript{61} [Reserved.]

\textsuperscript{62} [Reserved.]

\textsuperscript{63} [Reserved.]

\textsuperscript{64} [Reserved.]

\textsuperscript{65} [Reserved.]


\textsuperscript{68} Ralph Lauren Release, supra note 66, at 1.
and tangible benefits on companies that respond appropriately to violations and cooperate fully with the SEC."^{69}

Under the terms of the NPA, Ralph Lauren Corporation is required to disgorge more than $700,000 in illicit profits and interest paid by its Argentine subsidiary. In parallel criminal proceedings, the DOJ entered into an NPA with Ralph Lauren in which the company is required to pay an additional $882,000 penalty.^^70

§ 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. Successive Deputy Attorneys General have published memoranda governing the prosecution of business organizations. Although the most recent memorandum is the Filip Memorandum,^{76} companies should review previous memoranda to fully understand the DOJ’s positions, such as the Morford Memorandum,^{77} which provides principles regarding the appointment and use of independent corporate monitors. Other publications, including the Federal Sentencing Guidelines, provide non-binding guidance regarding criminal sentences.

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69. Id.
70. Id.
71. [Reserved.]
72. [Reserved.]
73. [Reserved.]
74. [Reserved.]
75. [Reserved.]
76. See infra section 5:5.2.
77. See infra section 5:5.6.
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. 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.

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 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;

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78. 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.

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.\(^\text{80}\)

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.”\(^\text{81}\) 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. As illustrated by the Lloyds TSB Bank plc DPA, 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, than later as a result of a government investigation. For example, the government’s investigation of General Reinsurance Corporation [described below in section 5:5.5[C]] resulted in an NPA based partly on the company sharing the results of its wide-ranging internal investigation, which uncovered malfeasance beyond the scope of the DOJ’s initial inquiries.

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 wrongdoers,” “efforts to pay restitution,” and “recognition of the flaws in [a company’s compliance] program and its efforts to improve the program.”\(^\text{82}\) 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. This is exemplified by the one-year DPA ABN AMRO received [discussed below in section 5:5.5[B]], based partly upon the company’s “extensive efforts at remediation.”

\(^{80}\) See USAM § 9-28.300.
\(^{81}\) See USAM § 9-28.720(a).
\(^{82}\) See USAM § 9-28.900.
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”).\(^{83}\) 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 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.”\(^{84}\)

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.\(^{85}\) The Guide identifies the hallmarks of strong compliance programs, while acknowledging that “there is no one-size-fits-all program.”\(^{86}\) The following are considered features of effective compliance programs:

- 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;


\(^{84}\) Id. at 54.

\(^{85}\) Id. at 56.

\(^{86}\) Id. at 57.
• 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.  

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 recent 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.  

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.  

For example, the DOJ noted that between 2002 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.

87.  Id. at 57–62.
88.  Id. at 77–79.
§ 5:5.4 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. 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.

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

89. 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.

90. See USAM § 9-28.720[a].
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.91

The Filip Memorandum prohibits prosecutors from requesting such waiver of any “core” attorney-client communications or work product.92 And, importantly, the DOJ may not condition cooperation credit upon the waiver of privilege.93 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.

91. See Filip Memorandum at 10.
92. See Filip Memorandum, supra note 78, § 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.”).
93. 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.”).
§ 5:5.5 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 simply to leave the company alone, 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. In a typical DPA, the government files a criminal complaint 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 complaint is dismissed with prejudice at the end of the deferral period.

94. 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.

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. 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 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.

[B] ABN AMRO

On May 10, 2010, the DOJ announced that it had entered into a one-year DPA with ABN AMRO Bank N.V. stemming from the bank’s alleged violations of the International Emergency Economic Powers Act, the Trading with the Enemy Act, and conspiracy to violate the Bank Secrecy Act. From 1995 through 2005, ABN allegedly facilitated the movement of hundreds of millions of dollars through the U.S. financial system, allowing countries such as Iran, Libya, Sudan, and Cuba to circumvent U.S. sanctions. Specifically, ABN removed references to sanctioned countries from payment messages, allowing the payment messages to pass through automated filters at U.S. financial institutions. As part of its deal with the government, ABN agreed to forfeit $500 million and to cooperate fully over the life of the agreement. Although the penalty was quite substantial, given the nature of the alleged conduct the consequences of a criminal conviction could have been far worse.

After several years of regulators raising concerns over ABN’s Bank Secrecy Act and anti-money laundering procedures, ABN

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99. ABN AMRO Deferred Prosecution Agreement ¶¶ 3, 6.
began an internal investigation into sanction violations, as a result of which ABN voluntarily disclosed its findings to U.S. investigators. In response to the results of this internal investigation, ABN made “extensive efforts at remediation,” including: (i) retaining independent outside firms to conduct an extensive transaction review of more than 35 million payment messages over a five-year period; (ii) enhancing transaction filtering processes globally; (iii) retaining an outside, independent firm to validate implementation of ABN’s Client Acceptance and Anti-Money Laundering Policy globally; (iv) creating a Compliance Committee of the Supervisory Board; (v) strengthening audit committee oversight; and (vi) disciplining and terminating culpable employees and executives. 100

Based on ABN’s remedial efforts, the DOJ agreed to defer prosecution for one year. In the DPA, the DOJ noted that it had considered, among other things, ABN’s voluntary agreement to a cease-and-desist order, ABN’s full compliance with the terms of previously filed civil complaints, and “the extraordinary remedial actions already taken by ABN, including the retention of an independent third party to conduct an extensive transaction review.” 101 The ABN agreement demonstrates that a thorough internal investigation that leads to extensive remedial efforts may be a key component to earning a DPA with the DOJ.

On December 28, 2011, Royal Bank of Scotland Group PLC (RBS), which had acquired ABN in 2007, announced that the DPA would expire on December 31, 2011, as the bank had fulfilled its obligations under the DPA. In a motion filed on December 20, 2011, the DOJ stated that RBS had “[met] the terms and obligations of the DPA, and has not otherwise breached the DPA” and therefore dismissed the charges.

[C] General Reinsurance Corporation

On January 19, 2010, the DOJ and General Reinsurance Corporation (“General Reinsurance”) entered into a three-year NPA. 102 The DOJ alleged that General Reinsurance engaged in a fraudulent scheme to falsely inflate American Insurance Group, Inc. (AIG)’s reported loss reserves. Under the NPA, General Reinsurance agreed to pay $60.5 million through a civil class action settlement to the AIG shareholders damaged by two sham transactions and $19.5 million to the U.S. Postal Inspection Service Consumer Fraud Fund. General Reinsurance

100. ABN AMRO Factual Statement ¶ 74 (on file with authors).
101. ABN AMRO Deferred Prosecution Agreement ¶ 5.
also agreed to institute remedial measures, including naming an independent director to its Board of Directors, establishing a Risk Committee charged with examining risk exposure in underwriting transactions, implementing enhanced underwriting rules for reinsurance and deposit transactions, and dissolving the subsidiary that helped structure the sham transactions.

In concluding that it would not charge General Reinsurance, the DOJ expressly noted General Reinsurance’s extraordinary cooperation, including its wide-ranging internal investigation. Specifically, the DOJ considered: (i) General Reinsurance’s investigation of the alleged criminal conduct; (ii) General Reinsurance’s continued cooperation with the DOJ and the SEC, which began in January 2005 and which assisted the DOJ in furthering its investigation against culpable individuals; (iii) General Reinsurance’s investigation and disclosure of other finite reinsurance transactions in addition to the sham transactions between the subsidiaries of General Reinsurance and AIG; (iv) General Reinsurance’s willingness to accept responsibility for the conduct of its senior officers; (v) General Reinsurance’s implementation of remedial measures to ensure that such conduct not recur and its commitment to continue to undertake these measures during the term of the NPA; and (vi) General Reinsurance’s demonstration of future compliance with the federal securities laws and Generally Accepted Accounting Principles.

The General Reinsurance agreement is significant as it illustrates the central role a thorough internal investigation can play in earning a company a DPA under the Filip Memorandum regime.

§ 5:5.6 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. A corporate monitor is an independent third party whose primary responsibility is to “assess and monitor a corporation’s compliance

103. See General Reinsurance Corporation Non-Prosecution Agreement, supra note 96.
104. [Reserved.]
105. [Reserved.]
106. [Reserved.]
with the terms of [its] agreement” with the DOJ. The Morford Memorandum makes clear that the appointment of a corporate monitor is “not to further punitive goals.” 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.

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.” 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;

108. Id. at 2.
109. Id.
111. Morford Memorandum, supra note 107, 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.  

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. Discussed below is one agreement in which the DOJ concluded that a monitor was warranted and another agreement in which the appointment of a monitor was unnecessary.


On May 5, 2009, the DOJ announced that it entered into a three-year DPA with Wellcare Health Plans, Inc. arising from allegations of a scheme to defraud the Florida Medicaid program and the Florida Healthy Kids Corp. program of approximately $40 million. Wellcare was required to forfeit the $40 million and pay an additional $40 million in restitution.

In addition to monetary sanctions, Wellcare was obligated to develop and implement effective corporate compliance measures and retain and pay for a period of eighteen months an independent monitor to review this process. Highlighting the intrusive nature of such an appointment,

112. Id. at 3–8.
the monitor was granted access to all non-privileged Wellcare documents the monitor determined were reasonably necessary to the execution of his or her duties. In addition, the monitor had the authority to interview any officer, employee, or agent of Wellcare.114

In its press release, the DOJ emphasized that this stringent agreement was a direct result of Wellcare’s “compliance program fail[ing] to prevent the misconduct alleged in the [i]nformation” and should “serve as a wake-up call for the corporate community to evaluate the effectiveness of their compliance plans to prevent criminal violations before they occur.”115 It is questionable whether a monitor would have been required had an internal investigation been timely commenced and remedial actions, including revisions to its compliance program, been voluntarily taken and reported to the DOJ.

[C] Helmerich & Payne

On July 30, 2009, the DOJ announced that it had entered into a two-year NPA with Helmerich & Payne (“H&P”) to resolve alleged violations of the FCPA arising from employees and agents of certain H&P subsidiaries bribing public officials in Argentina and Venezuela.116 As part of the NPA, H&P agreed to pay a $1 million penalty and implement certain internal controls. The DOJ, however, did not require the appointment of an independent corporate monitor.117 Instead, it allowed H&P to “self-report[]” to DOJ regarding its compliance program during the term of the NPA. Self-reporting by H&P likely included periodic updates to DOJ regarding the status of and improvements to H&P’s FCPA compliance program.

In discussing this case, then-Assistant Attorney General for the Criminal Division, Lanny Breuer, highlighted H&P’s self-disclosure of the bribes and its prompt cooperation with the DOJ as key reasons for why an independent monitor was not necessary:

The case was resolved through a NPA with a term of two years, a penalty of $1,000,000, which was approximately 33% below the bottom of the guideline range, and compliance self-reporting for a period of two years in lieu of an independent compliance monitor. Helmerich & Payne benefitted in several, very tangible ways from

114. Wellcare Health Plans, Inc. Deferred Prosecution Agreement, supra note 95.
117. See generally Letter from Kathleen M. Hamann, Trial Attorney, Fraud Section, to Kimberly A. Parker, Esq. (July 29, 2009), www.law.virginia.edu/pdf/faculty/garrett/helmerich.pdf.
their efforts. The fine, type of disposition, length of disposition, and treatment of the monitor issue all reflect the forward leaning, pro-active, highly cooperative approach taken here.\textsuperscript{118}

The H&P case and the Assistant Attorney General’s comments provide further support for the proposition that companies can avoid the appointment of an independent monitor by proactively conducting an internal investigation, self-reporting criminally suspicious conduct, and implementing appropriate remedial measures.

\section*{§ 5:5.7 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.\textsuperscript{119} 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.\textsuperscript{120}

The section of the Guidelines devoted to the sentencing of organizations is intended to “offer incentives to organizations to reduce and 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.”\textsuperscript{121} 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.\textsuperscript{122} 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.\textsuperscript{123} The section provides

\begin{itemize}
\item Id. § 8, Introductory Commentary.
\item Id. § 8B2.1.
\item See id. § 8C2.5.
\end{itemize}
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. 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.

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

124. See id. § 8C2.5 cmt. 12.
125. 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.”
126. [Reserved.]
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. 130

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, 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. 131 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

130. Id. cmt. n.6 [emphasis added].
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 Interpre-
tations Handbook and Information Memos in applying the
Incorporated NYSE Rules.132

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 fully cooperate with
investigation and enforcement proceedings. In a November 2008
release,133 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

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133. FINRA Regulatory Notice 08-70, FINRA Investigations: FINRA Provides
Guidance Regarding Credit for Extraordinary Cooperation (Nov. 2008),

(Securities Investigations, Rel. #5, 8/15) 5–43
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;
• 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.”134

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.

134. Id.
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.” 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.” 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, 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”.

135. Id.
136. Id.
137. Id.
• 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.”

§ 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 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 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

138. Id.
139. N.Y. GEN. BUS. LAW art. 23A.
proceeding under the Martin Act, the Attorney-General need not allege or prove either \textit{scienter} or intentional fraud.\textsuperscript{140}

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,\textsuperscript{141} and for felonies.\textsuperscript{142} But for purposes of this discussion, it is particularly worth noting the attorney general’s extremely broad subpoena and investigative powers.

\section*{§ 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.\textsuperscript{143} 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.\textsuperscript{144}

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.

\textsuperscript{140} State v. Rachmani Corp., 71 N.Y.2d 718, 725 n.6 (1988).
\textsuperscript{141} N.Y. GEN. BUS. LAW § 352-c(c)4.
\textsuperscript{142} 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.
\textsuperscript{143} N.Y. GEN. BUS. LAW § 352(4).
\textsuperscript{144} N.Y. GEN. BUS. LAW § 352(1).
§ 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.