WILMER, CUTLER & PICKERING

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SECURITIES AND EXCHANGE COMMISSION ISSUES FRAMEWORK FOR ITS EVALUATION OF COOPERATION IN ENFORCEMENT MATTERS

The Securities and Exchange Commission ("Commission") recently issued a Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934 (the "Report") explaining its decision not to take enforcement action against a public company after an investigation involving that company and the controller of one of the company's subsidiaries.[1] The staff had conducted an inquiry focusing on financial statement irregularities and, in its public report, the Commission set forth a framework for evaluating cooperation in determining how to resolve violations of the federal securities laws. In a news release accompanying the Report, the Commission stated, "Credit for cooperative behavior 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 Commission uses to announce and resolve enforcement actions."[2]

In sum, the Report sets forth the Commission's policy of encouraging self-reporting and greater cooperation with the Commission in any situation involving possible violations of the federal securities laws. The Commission believes that such cooperation will benefit investors and the marketplace. Through prompt and meaningful self-reporting of misconduct, companies may avoid protracted and costly enforcement proceedings, negotiate reduced charges and lighter sanctions, and possibly even avoid being named in an enforcement action altogether.

The Report is significant because, for the first time, it details the specific factors that the Commission will deem relevant in evaluating a company's cooperation and adopts, as official Commission policy, credit for self-policing, self-reporting, remediation, and cooperation.

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1 See Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934 and Commission Statement on the Relationship of Cooperation to Agency Enforcement Decisions, Exchange Act Release No. 44,969 Fed. Sec. L. Rep. (CCH) ¶74,985 (Oct. 23, 2001).

2 See News Release No. 2001-117 (Oct. 23, 2001), available at http://www.sec.gov/news/press/2001-117.txt.

The Seaboard Matter

The underlying matter involved an investigation of possible accounting irregularities at a subsidiary of Seaboard Corporation. In a settled administrative proceeding against the former controller of this subsidiary, the Commission found that, from 1995 through the first quarter of 2000, the controller caused both the subsidiary's and Seaboard's books and records to overstate certain deferred cost assets by over $7 million and to understate related expenses.[3] The Commission found that the subsidiary's and Seaboard's periodic reports had been misstated.[4] The Commission found that the former controller violated the books and records and reporting provisions of the Exchange Act.[5]

The Commission decided not to take any action against Seaboard. The 21(a) Report credited the following actions taken by Seaboard in making this decision:

First, "[w]ithin 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 [the controller] had caused the company's books and records to be inaccurate and its financial reports to be misstated."

Second, the full Board was advised and the Board then authorized the company to hire outside counsel to conduct a thorough inquiry.

Third, just four days later, the company fired the controller and two additional employees who Seaboard believed had inadequately supervised her.

Fourth, the next day, Seaboard informed the public and the Commission that its financial statements would be restated. The Report noted that the price of Seaboard's shares did not decline after this disclosure or after the restatement.

Fifth, Seaboard cooperated fully with the Commission staff, producing details of its internal investigation (including notes and transcripts of interviews) and not invoking the attorney-client privilege, work product protection, or other privileges or protections in connection with any facts uncovered in its investigation.

Finally, Seaboard strengthened the financial reporting processes of the subsidiary.

Framework for Evaluating a Company's Cooperation

The Report went beyond the facts of the Seaboard matter to present a framework for evaluating a company's cooperation in relation to enforcement decisions. The Commission explained, "When businesses seek out, self-report and rectify illegal conduct, and otherwise cooperate with Commission staff, large expenditures of government and shareholder resources can be avoided and investors can benefit more promptly." The Commission noted that existing federal securities laws, regulations, and guidance "promote and even require a certain measure of self-policing, self-reporting, and remediation."[6]

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[3] See In re Gisela de Leon-Meredith, Exchange Act Release No. 44,970 Fed. Sec. L. Rep. (CCH) ¶74,986 (Oct. 23, 2001). De Leon-Meredith is identified as the former controller of Chestnut Hill Farms, a Miami-based division of Seaboard Corporation. Seaboard is not identified in the Report, although it is identified in the In re de Leon-Meredith Order entered against the former controller.

[4] See id.

[5] See id.

[6] Report at n.2.

The Commission listed several caveats to the policy articulated by the Report. First, it stated that the paramount issue in every enforcement decision is, and must be, "what protects investors." In this regard, the Commission will consider the egregiousness of the misconduct and degree of harm caused, since "there may be [some] circumstances where conduct is so egregious, and harm so great, that no amount of cooperation or other mitigating conduct can justify a decision not to bring any enforcement action at all." Accordingly, the Commission will evaluate the nature of the misconduct itself, including the wrongdoer's mental state (e.g., inadvertent vs. deliberate indifference) and the seniority of the person(s) involved. For example, it is unlikely that the Commission would determine not to bring an action if senior management had participated in, or even "turn[ed] a blind eye" to, the misconduct. The Commission will consider how long the misconduct lasted and how much harm it has inflicted on investors (not a concern in the Seaboard matter because the stock price was not affected by the disclosure of the misconduct or the restatement). It is likely that even where the Commission decides it should bring an enforcement action, a company's quick response, disclosure, remediation, and cooperation may lead to reduced charges or a lighter sanction.

Second, the Commission did not purport to adopt a bright-line rule or to make any commitment or promise about any specific case. The Report was carefully crafted so as not to limit the agency's broad discretion to evaluate every case individually on its own particular facts and circumstances.

Third, the Commission made clear that it may consider some or all of the criteria listed, as well as other criteria not mentioned in the Report.

Criteria To Be Considered

The Report provides extensive guidance on the factors to be considered by the Commission in determining whether, and how much, to credit self-policing, self-reporting, remediation, and cooperation. As made clear by the press release accompanying the Report, these criteria fall into four basic categories:

1. *Self-policing before the discovery of the misconduct.*

The Commission will evaluate the corporate environment in which the violation(s) occurred and the degree to which a company engages in "self-policing." This self-policing may include establishing effective compliance procedures and an appropriate tone at the top. For example, does the company have adequate compliance procedures? Is management setting the appropriate tone or is there "a tone of lawlessness set by those in control of the company?" Additionally, the Commission will consider whether the misconduct was symptomatic of a larger problem in the way in which the company does business.

2. *Self-reporting misconduct when it is discovered.*

The Commission will evaluate the company's discovery of, and response to, the misconduct. Such a response may include conducting a thorough review of the nature, extent, origins, and consequences of the misconduct and promptly, completely, and effectively disclosing the misconduct to the public, regulators, and self-regulators. How the misconduct was discovered and who detected it is important. Although not specifically mentioned in the Report, it is likely that the Commission would look more favorably on a company that discovered misconduct through a regular and systematic internal audit function, compared with one that discovered the misconduct by accident. Equally if not more important is the company's response to the discovery of any misconduct — in terms of timeliness, dealing with those persons found responsible, disclosure to the government and investors, thoroughness of the internal investigation (that is, "a thorough review of the nature extent, origins and consequences of the conduct and related behavior"), and competence and oversight of the persons conducting the review.

3. Remedial measures.

The Commission will evaluate a company's remedial measures taken to prevent a recurrence of the misconduct. These remedial measures may include dismissing or appropriately disciplining wrongdoers, modifying and improving internal controls and procedures to prevent recurrence of the misconduct, and appropriately compensating those adversely affected. Also relevant is any change in company management since the misconduct occurred.

4. Cooperation with law enforcement authorities.

Finally, the Commission will consider the company's cooperation with the Commission staff and other law enforcement authorities. This cooperation may include promptly informing the staff of the results of any internal review, producing a "thorough and probing written report detailing the findings of its review," and encouraging employee cooperation. Such cooperation also may include the provision of otherwise privileged or protected communications and attorney work product, as was the case with Seaboard.

The Commission appears to have been careful in not seeming to require a company to waive attorney-client, work product, and related privileges and protections. The Report notes:

> The Commission recognizes that these privileges, protections and exemptions serve important social interests. In this regard, the Commission does not view a company's waiver of a privilege as an end in itself, but only as a means (where necessary) to provide relevant and sometimes critical information to the Commission staff.[7]

A more extreme Commission position on this issue, i.e., demanding waiver as a demonstration of a company's cooperation, would put a company in the unfortunate predicament of choosing between "full" cooperation with the Commission and avoiding the risk that privileged or otherwise protected communications and materials may end up in the hands of private litigants. In McKesson HBOC, Inc., et al. v. Adler,[8] one of the issues was whether McKesson HBOC's production of work product prepared in the course of an internal investigation to the Commission, pursuant to a confidentiality agreement, waived the company's work product protection as to third parties. As the Report notes, the Commission filed an amicus brief in McKesson HBOC, in which it argued that McKesson HBOC's sharing of privileged information with the staff in accordance with the confidentiality agreement did not waive the privilege as to third parties. In that brief, the Commission reasoned, "When the Commission can conduct expeditious and efficient investigations, it can then obtain appropriate remedies for investors in a more timely manner" and thereby best serve the public interest.[9] Unfortunately for companies facing such a decision, the Commission's view has not been adopted by many federal courts.

Precedent: Commission Actions and Department of Justice Guidelines

There is significant precedent (from the Commission and from other government sources) for the framework set forth by the Commission in the Report. The Report, however, is notable for its clear articulation of this framework and for its clear message that companies may expect benefits from vigorous self-policing, self-reporting, remediation, and cooperation.

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7 Report at n.3.

8 Civil Action No. 99-C-7980-3 (Ga. Ct. App. Filed May 31, 2001).

9 Brief of SEC as Amicus Curiae in McKesson HBOC, Inc., at 23.

The Report cites a number of cases and other support for a company's obligations to perform these duties. In particular, the Report cites Section 10A of the Exchange Act (requiring issuers and auditors to report certain illegal conduct to the Commission); In re W.R. Grace & Co.[10] (issued to "emphasize the affirmative responsibilities of corporate officers and directors to ensure that the shareholders whom they serve receive accurate and complete disclosure of information required by the proxy solicitation and periodic reporting provisions of the federal securities laws"); In re Cooper Companies, Inc.[11] (issued to "emphasize that corporate directors have a significant responsibility and play a critical role in safeguarding the integrity of the company's public statements and the interests of investors when evidence of fraudulent conduct by corporate management comes to their attention"); In re John H. Gutfreund[12] (imposing sanctions against senior management of a broker-dealer who failed to promptly bring misconduct to the government's attention); the Federal Sentencing Guidelines § 8C2.5(f) & (g) (reducing organization's "culpability score" for having an effective program to prevent and detect illegal actions or for prompt voluntary disclosure to the government); and NYSE Rules 342.21 & 351(e) (requiring members and member firms to conduct trade review compliance and prompt internal investigations, and to report the results/status of these investigations).[13]

Moreover, the Report's framework is similar to the Department of Justice guidelines published in June 1999, entitled "Federal Prosecution of Corporations," which list many of the same mitigating factors to be considered in determining whether to **prosecute a corporation**.[14] These factors include:

(1) the "nature and seriousness of the offense, including the risk of harm to the public;"

(2) the "pervasiveness of wrongdoing within the corporation, including the complicity in, or condonation of, the wrongdoing by corporate management;"

(3) the company's "timely and voluntary disclosure of wrongdoing and its willingness to cooperate in the investigation of its agents, including, if necessary, the waiver of the corporate attorney-client and work product privileges;"

(4) the "existence and adequacy of the corporation's compliance program;" and

(5) "remedial actions, including any efforts to implement an effective corporate compliance program or to improve an existing one, to replace responsible management, to discipline or terminate wrongdoers, to pay restitution, and to cooperate with the relevant government agencies."

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[10] Exchange Act Release No. 39,157, [1997 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶85,963 (Sept. 20, 1997).

[11] Exchange Act Release No. 35,082, 58 S.E.C. Docket 591 (Dec. 12, 1994).

[12] Exchange Act Release No. 31,554, 52 S.E.C. Docket 2849 (Dec. 3, 1992).

[13] Additional examples of the Commissions' consideration of a company's cooperation are: In re Am. Bank Note Holographics, Inc., Exchange Act Release No. 44,563, 75 S.E.C. Docket 912 (July 18, 2001) (company conducted internal investigation, made findings available to Commission staff, continued to cooperate with staff in its investigation, and replaced its former senior management); In re Cendant Corp., Exchange Act Release No. 42,933, 72 S.E.C. Docket 1550 (June 14, 2000) (considering company's "thorough" internal investigation, "extensive" report, waiver of privileges, and cooperation with Commission investigation in fixing appropriate sanction); In re Collins Indus., Inc., Exchange Act Release No. 34,934, 57 S.E.C. Docket 2443 (Nov. 3, 1994) (company, through counsel, conducted internal investigations and provided Commission with results of investigations and access to professionals who conducted them).

[14] Available at http://www.usdoj.gov/criminal/fraud/policy/Chargingcorps.html.

The Report may reflect the Commission's wish to align itself more closely with these guidelines.

CONCLUSION

Issuance of the Report initially put the Commission on the defensive. The day after the Report was released, The Wall Street Journal described it as the "latest sign that the Securities and Exchange Commission intends to be less confrontational under new Chairman Harvey Pitt."[15] According to the Journal, "The move represents a major change in tone from the unabashed activism of the [C]ommission under former Chairman Arthur Levitt, whose top priorities included championing the interests of individual investors by pursuing high-profile accounting-fraud actions."[16] In a speech to securities lawyers in New York on November 8, Chairman Pitt denied that the Report's framework suggested that the Commission had gone " 'soft' on securities violations or financial fraud."[17] The Report also prompted criticism from investor groups that believed it could be used as some type of amnesty program for companies seeking to avoid accountability for past misconduct and that companies might be encouraged to shift the blame to their employees in order to avoid their own liability.

Much of the impact of the Commission's "new" policy of encouraging company cooperation through the promise of receiving "credit" for this cooperation (either through reduced charges, lighter sanctions, or no enforcement action at all) will depend on how it is applied in the future. According to the Commission's Director of Enforcement, Stephen M. Cutler, "Crediting those who seek out, self-report, and rectify illegal conduct is critical to achieving the Commission's goal of 'real-time enforcement.'"[18] In his November 8 remarks, Chairman Pitt elaborated that the goal of "real-time enforcement" is to take preliminary actions against securities violators to prevent loss of investor funds.[19] Accordingly, companies that assist the Commission in expediting an investigation may reap the rewards of no enforcement action, reduced charges, or lighter sanctions. On the other hand, a company that uncovers misconduct has to consider the possible negative consequences of not conducting a thorough internal investigation, reporting its findings to the Commission (or other regulator or law enforcement authority), and taking prompt remedial action. Will that company face more severe charges and sanctions now that the Commission has taken such strong measures to encourage these actions?

The Report's express articulation of the factors relevant to the SEC's assessment of self-policing, self-reporting, remediation, and cooperation will be extremely valuable to a broad constituency of American corporations and to the senior decision-makers in these companies. The criticism leveled at the Commission, and particularly at the new Chairman is misplaced. Giving credit for cooperation is not new; making it official Commis-

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15 Michael Schroeder & Jonathan Weil, SEC Chooses a More Lenient Tack, Companies May Avoid Penalties by Reporting Misdeeds, Cooperating, Wall St. J., Oct. 24, 2001, at C1.

16 Id. See also Editorial, The Levitt Legacy, Wash. Post, Oct. 28, 2001, at B06 (expressing concern that, under Pitt's reign, the Commission may "go soft on auditing standards").

17 Matt Andrejczak, Pitt: SEC not 'soft' on enforcement, CBS.Marketwatch.com (Nov. 8, 2001).

18 Press Release, SEC Issues Report of Investigation and Statement Setting Forth Framework for Evaluating Cooperation in Excercising Prosecutorial Discretion (Oct. 23, 2001) available at http://www.sec.gov/news/press/2001-117.txt.

19 Matt Andrejczak, Pitt: SEC not 'soft' on enforcement, CBS.Marketwatch.com (Nov. 8, 2001).

sion policy, with the relevant factors and considerations articulated publicly, is new.

Critics of the Commission, and of law enforcement agencies in general, may be offended at the notion of credit being given to those who break the law. That credit, however, is simply a reality in the effective use of law enforcement resources. Investors who are promptly compensated on a voluntary basis by a company that is trying to win credit with the Commission will be well-served if the program is administered properly. Commission staff lawyers and accountants who complete an investigation expeditiously — as a result of cooperation — will get assigned to new or understaffed investigations. In addition, giving credit to those who cooperate is a matter of simple fairness.

In the Report, the Commission at least has achieved a higher degree of transparency as to the factors that will inform the agency's assessment of how relevant such cooperation is to its enforcement decisions. Whether we agree with the decisions the agency ultimately reaches in the specific application of these criteria is secondary to the question of whether the issuance of the Report is good public policy. On balance, the answer to that question is yes.

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