Legal Backgrounder

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SEC SELF-POLICING POLICY PRESENTS BENEFITS AND PITFALLS

by

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Following the release last year of the so-called "Holder-Memorandum" by the Department of Justice,[1] on October 23, 2001, the Securities and Exchange Commission (the "SEC" or the "Commission"), pursuant to Section 21(a) of the Securities Exchange Act of 1934, issued a report of investigation outlining some of the criteria that it will consider when assessing the extent to which a company's self-policing and cooperation efforts will influence its decision whether to bring an enforcement action against a company for federal securities law violations.[2] *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,* Exch. Act Rel. No. 44969 (Oct. 23, 2001) (the "Report").[3]

In its press release announcing the Report, the Commission identified four broad factors that may influence its evaluation of a company's cooperation:

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[1]The Holder-Memorandum refers to the Department of Justice release titled *Federal Prosecution of Corporations* which provides guidance as to what factors prosecutors would generally consider in making the decision whether to charge a corporation in a particular case. The Holder-Memorandum can be found at http://www.usdoj.gov/criminal/fraud/policy/Chargingcorps.html.

[2]Typically, a Section 21(a) [15 U.S.C. § 78u(a)] report provides the Commission with an opportunity to signal its future enforcement posture on an issue without having to allege that the federal securities laws have been violated. This Report marks the first time that the Commission has used the Section 21(a) report of investigation in this manner.

[3]The Report can be found at http://www.sec.gov/litigation/investreport/34-44969.htm.

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1. Self-policing prior to the discovery of the misconduct, including establishing effective compliance procedures and an appropriate tone at the top;

2. Self-reporting of misconduct when it is discovered, including 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, to regulators, and to self-regulators;

3. Remediation, including dismissing or appropriately disciplining wrongdoers, modifying and improving internal controls and procedures to prevent recurrence of the misconduct, and appropriately compensating those adversely affected; and

4. Cooperation with law enforcement authorities, including providing the Commission staff with all information relevant to the underlying violations and the company's remedial efforts.[4]

While making clear that it was not adopting a rule or limiting its enforcement discretion, the Commission indicated that where a company takes the steps outlined in the Report it may exercise its discretion and "credit" the company for its remedial efforts. Such "credit for cooperative behavior," the Commission says, "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."[5]

The Report. The Report outlined in detail the steps taken by Seaboard Corporation, the company that was the subject of the SEC's investigation, after it discovered that it may have violated the federal securities laws. Within a week of learning about the misconduct, Seaboard conducted a preliminary investigation, advised company management who, in turn, advised the Board's audit committee. Subsequently, Seaboard's board of directors authorized the company to engage independent outside counsel to conduct a detailed investigation. Four days later, Seaboard dismissed the former controller who caused the inaccuracies in its books and records along with two others who had inadequately supervised the controller. A day later, Seaboard publicly disclosed that its financial statements would be restated. The price of Seaboard's shares did not decline after the announcement or after the restatement was published.

Furthermore, Seaboard provided the SEC with all relevant information concerning the alleged violations. Seaboard produced details of its internal investigation (including notes and transcripts of interviews) and declined to invoke its attorney-client privilege, work product protection or other privileges or protections with respect to the investigation. In addition, Seaboard strengthened its financial reporting processes to address the controller's conduct.

Based on the foregoing, the Commission resolved not to bring enforcement action against Seaboard. However, in announcing its settlement with the controller, the Commission stated that Seaboard violated Sections 13(a) and 13(b)(2) of the Securities Exchange Act of 1934.

After outlining Seaboard's cooperative efforts, the Report listed thirteen questions that the Commission

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[4]The press release can be found at http://www.sec.gov/news/headlines/prosdiscretion.htm.

[5]*See In the Matter of Baker Hughes Incorporated* for an example of an enforcement action in which the Commission included mitigating language in the document used to announce and resolve an enforcement action. Exch. Act Rel. No. 44784 (Sept. 12, 2001).

believes will help its staff in determining whether to recommend enforcement action against a company under investigation for possible violations of the securities laws. Broadly, the Commission flagged the following criteria as important:

(i) the nature of the misconduct involved
(ii) how did the misconduct arise?;
(iii) where in the organization did the misconduct occur?;
(iv) the duration of the misconduct;
(v) how much harm has the misconduct inflicted upon investors and other corporate constituencies, and did the share price of the company's stock drop significantly upon its discovery and disclosure?;
(vi) how was the misconduct detected and who uncovered it?;
(vii) how long after discovery of the misconduct did it take to implement an effective response?;
(viii) what steps did the company take upon learning of the misconduct?;
(ix) what processes did the company follow to resolve many of these issues and ferret out necessary information?;
(x) did the company commit to learn the truth, fully and expeditiously?;
(xi) did the company promptly make available to our staff the results of its review and provide sufficient documentation reflecting its response to the situation?;
(xii) what assurances are there that the conduct is unlikely to recur?; and
(xiii) is the company the same company in which the misconduct occurred, or has it changed through a merger or bankruptcy reorganization?

While practitioners before the SEC's Enforcement Division may not have been surprised by the criteria outlined in the Report, what is most noteworthy is the Commission's willingness to disclose how it plans to make enforcement decisions where companies self-police and cooperate with its investigations. In what the new SEC Chairman referred to as a new era of "civility and cooperation," perhaps the biggest benefit of the Report is that it demystifies the SEC staff's decision making process.[6] Furthermore, the Report provides companies with potential enforcement problems with a new confidence to actively seek out the Commission and self-report. Acknowledging as much, Stephen Cutler, the Commission's new Director of Enforcement, said, "it will bring in more cases and use fewer resources" thereby offering "more protection for investors." Maureen Milford, *A Kinder Gentler SEC*, NAT'L LAW J., Nov. 7, 2001. In addition to fostering what the SEC Chairman calls the new kinder and gentler agency, the SEC's new posture can be seen as encouraging a collaboration between the public and private sector in promoting and enhancing the securities markets.

The Downside: Waiving Attorney-Client Privilege. Notwithstanding the obvious benefits of cooperation, voluntary disclosure of attorney-client or work product privileged information to the SEC staff, even when disclosed pursuant to a confidentiality agreement, is fraught with pitfalls that can often have dire consequences for a company facing multiple investigations by federal or state agencies or other private litigants.[7] Once a company discloses privileged information, its ability to protect the privilege, at least as to

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[6]Chairman Harvey Pitt, *Remarks Before the AICPA Governing Council* (Oct. 22, 2001). The speech can be found at http://www.sec.gov/news/speech/spch516.htm.

[7]As a matter of policy, federal agencies typically share documents and information with each other. *See*, *e.g.*, 44 U.S.C. § 3510(a) (1988) (agencies can make available to other agencies "information obtained pursuant to an information collection request"); 22 U.S.C. § 2575 (1988) (permitting information exchange between the United States Information Agency, Defense Department and other agencies); 15 U.S.C. § 57b-2(b)(6) (1994) (authorizing the Federal Trade Commission to share information with other federal and state law enforcement agencies).

private third party litigants, may well depend upon the jurisdiction overseeing the litigation. Mindful of this problem, the Commission in a footnote in the Report noted that it 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."

The federal courts that have addressed the waiver issue have by and large held that voluntary disclosure of privileged information to a government agency operates as a waiver of the privilege at least with respect to the specific materials disclosed.[8] While in some jurisdictions a confidentiality agreement might go some way to protect privileged information, at least one federal court has held that the disclosure of privileged information operates as a waiver regardless of the existence of a confidentiality agreement. *In re Columbia/HCA Healthcare Corp.*, 192 F.R.D. 575, 578-579 (M.D. Tenn. 2000). Thus, the decision to waive attorney client or work product privilege ought to be approached with caution particularly in the early days of an investigation that may take several years to resolve. Where it is possible, the prudent course would be to cooperate fully with the SEC investigation while preserving the company's privilege. In cases where it becomes necessary to disclose privileged information, negotiating a strong confidentiality agreement is critical.

In short, the message is that cooperation is now more important than ever, but companies should be very careful about what they disclose for not even the SEC has the ability to preserve a company's privilege.

Conclusion. While the Report in many ways codifies what many SEC practitioners have long understood, it offers companies facing SEC investigations and their counsels a roadmap with which to navigate the enforcement process and possibly avoid enforcement action altogether. However, questions remain as to how sensitive the staff will be to the issue of privilege. Indeed, only in very limited circumstances should a company be willing to completely waive its privileges in the manner in which, for example, Seaboard did. How this and other strategic questions are answered either by the Commission or by the courts will go a long way in determining how beneficial the new SEC stance proves to be for businesses.

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[8] *See United States v. Massachusetts Institute of Technology*, 129 F.3d 681, 686 (1st Cir. 1997); *In re Steinhardt Partners, L.P.*, 9 F.3d 230, 236 (2d Cir. 1993); *Westinghouse Electric Corp. v. Republic of the Philippines*, 951 F.2d 1414, 1431 (3d Cir. 1991); *In re Martin Marietta Corp.*, 856 F.2d 619, 623-624 (4th Cir. 1988); In re *Grand Jury Proceedings*, 78 F.3d 251, 254-255 (6th Cir. 1996); *Permian Corp. v. United States*, 665 F.2d 1214, 1222 (D.C. Cir. 1981); *McMorgan & Co. v. First California Mortgage Co.*, 931 F. Supp. 703, 711 (N.D. Cal. 1996). The Eighth Circuit is currently the only circuit which holds that the attorney-client privilege survives disclosure of confidential information to a governmental agency. *See Diversified Indus. Inc. v. Meredith*, 572 F.2d 596, 611 (8th Cir. 1978). Courts in the Fifth, Seventh, Tenth and Eleventh Circuits have yet to consider the issue.