# NYSE: Corporate Governance Guide

# 29 Handling regulatory inquiries, investigations, and settlements

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We live in an era of heightened regulatory scrutiny of public companies. As Mary Jo White, the chair of the US Securities and Exchange Commission (SEC), promised at her confirmation hearing, the SEC is pursuing an enforcement strategy that is "bold and unrelenting." In today's regulatory climate, companies increasingly are being judged by the way they respond to investigations, and any perceived failure to respond appropriately can have severe consequences. As a result, companies must react swiftly and effectively when confronted with an inquiry. This chapter summarizes key practical considerations in responding to an investigation.

## Who are the regulators and what do they investigate?

The SEC is the primary regulator of public companies and is a law enforcement agency. SEC investigations are conducted by the staff of the Division of Enforcement (Staff). These investigations involve the full range of issues under the federal securities laws, including improper financial reporting, misleading disclosures, incorrect accounting, false filings and offerings, inadequate internal controls, inaccurate books and records, insider trading, stock manipulation, misappropriation of assets, and anticorruption violations. Each year, the SEC brings hundreds of civil and administrative enforcement actions.

While this chapter focuses on SEC investigations, many of the practical considerations also apply to inquiries conducted by other law enforcers, including the US Department of Justice (DOJ), state securities departments and attorneys general, and regulators such as the Commodity Futures Trading Commission, Financial Industry Regulatory Authority, and Public Company Accounting Oversight Board. High-profile investigations often can lead to a media blitz, shareholder litigation, delisting, and reputational harm, as well as capture the attention of Congress.

## The commencement of an investigation

SEC investigations, like most others, can begin in a variety of ways—from the informal (such as a call from an investigator or a voluntary

letter request) to the formal (such as a subpoena for documents or testimony). The Staff is authorized to conduct informal inquiries, called Matters Under Inquiry (MUIs), or formal investigations upon the issuance of a Formal Order of Investigation (Formal Order). Formal Orders designate members of the Staff to act as officers of the SEC for purposes of conducting the investigation, including issuing subpoenas to compel the production of documents and testimony.

### Practice Pointer

Any person who is compelled or requested to furnish documents or testimony has the right to request and be shown the Formal Order. To receive and retain a copy, however, such persons must follow certain procedures in sending a written request, and approval of the request is at the discretion of the Staff (although such requests typically are granted). See Rule 7(a) of the SEC's Rules Relating to Investigations, 17 C.F.R. § 203.7(a); see also SEC Enforcement Manual, Section 2.3.4.2. While Formal Orders are generic in nature, they do provide some information with respect to the potential violations being investigated.

Regardless of how investigations start, companies should take them seriously and avoid compounding problems by failing to stop ongoing violations, destroying or failing to preserve documents, making inaccurate or false statements, or doing anything else that results in losing credibility. Throughout the course of an investigation, companies should remember that credibility and cooperation are key. The SEC and DOJ, among others, have issued frameworks for obtaining cooperation credit during an investigation. See, for example, SEC Enforcement Manual, Section 6; United States Attorneys' Manual, Title 9-28.

## Disclosing the investigation

There is no line-item requirement under the federal securities laws requiring that public companies disclose investigations. Instead, companies must determine whether the facts and circumstances require line-item disclosure (for example, under Item 103 of Regulation S-K) or if disclosure is required because the investigation is quantitatively or qualitatively material. In doing so, companies should assess the probability and magnitude of the outcome of the investigation, including whether any potential losses are probable and reasonably estimable. In addition, issues or events that arise during or as a result of the investigation may themselves require disclosure (for example, if significant errors in previously issued financial statements are uncovered).

If required, disclosure should be prompt and complete. If not required, companies should consider whether to make a voluntary disclosure, including assessing factors such as the ability to place the issues in context and the likelihood of the investigation becoming known without disclosure. The timing of disclosure is critical. It can be premature if the details and depth of the potential problems are unknown and end up understated, or too late if it is perceived that a company did not react in a timely fashion. Company securities counsel should be consulted on all disclosure issues.

### Practice Pointer

Companies should consider implementing crisis communications plans to deal with the marketplace, as well as employees, customers, vendors, and the like. These plans can be developed generally in advance of any problem and tailored to specific situations as they arise, and they can be helpful at all stages of an investigation (from initial disclosure through resolution). In developing communications plans, companies should assess whether a public relations firm should be engaged. If feasible, the engagement should be made through counsel to preserve the attorney-client privilege and to protect work product.

## Preserving relevant evidence

Upon receiving notice of an investigation, companies should take immediate action to preserve potentially relevant documents, including considering the following steps:

1. Identify a list of individuals who might have information and documents relevant to the investigation and, if necessary, expand the list as more information is learned.
2. Send written notices to these individuals instructing them to preserve hard-copy and electronic documents. Provide examples of the types of documents to be preserved (including documents that might not be readily apparent, such as instant and text messages and voicemails), as well as the potential locations of such documents. Instruct personnel to err on the side of being overinclusive in their preservation efforts and to preserve all originals, drafts, and duplicates. If practical, obtain representations or certifications from personnel stating that they are complying with the preservation memoranda.

### Practice Pointer

For certain personnel, the circumstances also might warrant taking control of hard-copy documents, hard drives, laptops, and personal devices. In this regard, companies should not rely on certain individuals to preserve documents, particularly if it is possible they were involved in potential wrongdoing. Companies should take immediate control of all files of suspected wrongdoers.

3. Work with company technology personnel to preserve electronic documents, and consider using an outside document vendor retained through counsel. Ensure that all relevant documents are preserved even if they are scheduled for routine disposal as part of a pre-existing policy. If electronic documents are not automatically archived, consider retaining relevant backup tapes and ceasing recycling of such tapes. Take a "snapshot" of the email system and other servers and databases as appropriate.
4. If the authority conducting the investigation issues a preservation notice, the specific terms must be followed—clarification or modification can be sought as necessary.

## Collecting, reviewing, and producing documents

There are different options for collecting documents, ranging from self-collection by asking individuals to provide documents for review and production, to guided collection by interviewing individuals to identify responsive documents, to more centralized collection by imaging individuals' hard drives and conducting "office sweeps." Companies also should collect noncustodial responsive documents, such as centrally stored hard-copy or electronic documents, and use a system to track the source of documents and compliance with collection requests. Failure to collect and produce all responsive documents and properly comply with a subpoena can create negative inferences and even lead to self-standing proceedings to enforce the subpoena—something the SEC has trumpeted in recent pronouncements and acted on by marching into federal court.

### Practice Pointer

Companies should determine if responsive documents from former employees have been maintained. Similarly, companies should consider collecting from individuals who depart the company during the investigation (for example, retaining their hard drives).

Much of the early part of the investigation will be spent reviewing and producing documents. In doing so, companies should consider the following steps:

1. Use a database provided by a qualified vendor to store, review, and produce collected documents.
2. For larger requests, consider using search terms to identify potentially responsive documents.

### Practice Pointer

Discussing search terms and related issues with the authority conducting the investigation can help ensure that the company is responding appropriately. Depending on the circumstances, agreements to narrow certain aspects of a request or subpoena can be reached.

3. Review and code all documents for responsiveness and privilege. This process also can be used to identify key documents that will be useful as the investigation proceeds.

### Practice Pointer

The review process will depend on the nature of the documents. In addition to a privilege review, companies should consider whether documents might contain information that is personal, proprietary, or covered by statutory privileges or protections. If documents reside outside of the US, companies should be cognizant that foreign jurisdictions often have data-protection laws and other legal restrictions.

4. Comply with the instructions in the request or subpoena when determining the mechanics and format of productions and be transparent about production protocols (for example, identifying the reasons for redactions).
5. Where permissible, request confidential treatment of the documents, including notification of requests made by third parties to access the documents.

### Practice Pointer

Whether confidential treatment can be requested will depend on the authority conducting the investigation. For example, the SEC has specific requirements for making confidential treatment requests under the Freedom of Information Act (FOIA). See, for example, 17 C.F.R. § 200.83. Conversely, certain other regulators do not permit requests for confidential treatment.

## Inquiring into the facts

Companies should begin inquiring into the facts as soon as possible. In certain instances, this might warrant an independent internal investigation—but, in others, it might involve a less formal review. In either case, the ultimate goal is to uncover and assess all of the facts (the good, bad, and ugly).

### Practice Pointer

Factors to consider when deciding whether to conduct an internal investigation include the egregiousness of the potential problem, the likelihood that financial statements or disclosures will be affected, whether the problem is systemic in nature, and how many individuals are involved and their seniority levels. Related questions include who should oversee the investigation (for example, management, the board, the audit committee, or a special board committee) and who should conduct it (for example, internal audit, in-house counsel, outside defense counsel, or independent outside counsel with no prior relationship with the company). To answer these questions, companies also should consider (1) the credibility of the investigation with the regulators, (2) efficiencies from using investigators familiar with the company, and (3) conducting the review under the attorney-client privilege.

Identifying key documents and conducting interviews are important parts of the fact-gathering process (whether or not a formal internal investigation is undertaken). As for interviews, companies should consider the following steps:

1. Generate a list of interviewees. Be aware that multiple interviews of the same individual may be necessary as further information is uncovered.
2. Determine whether cooperation of personnel can be required (through board resolution or otherwise) and what actions can be taken if an individual refuses to submit to an interview.

### Practice Pointer

Under the Dodd-Frank Wall Street Reform and Consumer Protection Act, there are antiretaliation provisions prohibiting employers from taking adverse employment actions against whistle-blowers. Companies should consider these provisions (along with other relevant restrictions under employment law or otherwise) before requiring employees to submit to interviews under threat of termination for noncooperation.

3. Determine the subject areas of inquiry. In addition to substantive issues, cover the interviewees' document collection efforts and the identity of other individuals who might have relevant information.
4. Have two interviewers present at each interview to assure proper documentation of what was said and to avoid misunderstandings.
5. Provide Upjohn warnings at the outset, notifying interviewees that (1) counsel represents the company and not the interviewees, (2) the interview is being conducted to gather facts in order to provide legal advice to the company, (3) the discussion during the interview is privileged, but the privilege belongs solely to the company, not the interviewees, (4) the company can elect to waive the privilege and disclose the discussion to third parties, including regulators, without obtaining the interviewees' consent, and (5) the interviewees must keep the discussion in confidence and may not discuss the substance of the interview with anyone but counsel.

### Practice Pointer

Interview notes or memoranda should reflect the fact that Upjohn warnings were provided, and companies should consider whether written acknowledgments should be obtained from interviewees.

6. Determine how to document interviews. Keep in mind that this documentation, including notes or formal interview memoranda, could be susceptible to production to the regulators (and possibly in civil litigation). Avoid verbatim recitations and use appropriate legends that identify the documentation as being covered by the attorney-client privilege and attorney work product doctrine.

## Preparing for and defending testimony

If testimony is required, companies should determine whether and to what extent witnesses should be represented by separate counsel. (In some instances, individual representation already may have been secured—for example, in advance of internal interviews.) Depending on the circumstances, company counsel might represent certain individuals, or individual counsel might represent multiple witnesses, but potential conflicts of interest need to be considered. Company counsel also should assess the feasibility and advisability of entering into oral or written joint defense or common interest agreements with counsel for others. In addition, companies should determine whether it is mandatory or permissive to provide advancement of legal expenses (and, ultimately, indemnification)

to individual directors, officers, or other employees, as well as the prerequisites for doing so—for example, undertakings to repay advanced funds.

### Practice Pointer

SEC rules provide for witness sequestration and prohibit witnesses or their counsel from being present during the testimony of other witnesses (unless permitted in the discretion of the officer conducting the investigation). See Rule 7(b) of the SEC's Rules Relating to Investigations, 17 C.F.R. § 203.7(b). Counsel, however, is permitted to represent and defend the testimony of more than one witness. See SEC Enforcement Manual, Sections 3.3.5.2.2 and 4.1.1.1. During testimony, the Staff will typically ask counsel to confirm that they represent the witness. Accordingly, if company counsel intends to appear at testimony and is not already representing the witness, they should consider discussing this in advance with the Staff or entering into a limited representation for the purpose of defending the witness at testimony.

Preparation is crucial for any testimony, and sufficient time should be reserved to cover all potential areas of inquiry. Company counsel should already have an extensive understanding of the facts and issues, and the goal of preparation should be to help ensure that truthful, complete, and credible testimony is provided. Witnesses who do not recall much of anything, particularly if the facts at issue are recent or of a memorable nature, are not received well—and they can be perceived as noncooperative or even obstructionistic.

SEC and other regulatory testimony is not governed by evidentiary or civil procedure rules, but counsel should avoid the appearance of impeding the inquiry or coaching the witness during testimony. Counsel, however, can ask for clarification, as well as ask the witness substantive questions. This needs to be done effectively and for the purpose of creating a clear record.

### Practice Pointer

Experienced securities enforcement practitioners typically do not "object" during SEC testimony. This notwithstanding, counsel should interject appropriately if an examiner goes out of bounds in terms of questions that call for privileged information, irrelevant questions, inaccurate statements of fact, poor treatment of the witness, or the like.

At the end of SEC testimony, counsel should request confidential treatment of the testimony under FOIA and follow up with a written request. Counsel may also request a copy of the testimony transcript, but sometimes it is advisable not to do so—for example, if there is ongoing civil litigation, counsel may decide not to request a transcript (but, even then, it could be subject to discovery).

## Taking appropriate proactive steps

Based on an assessment of the facts, companies should consider taking appropriate proactive steps, including deciding whether to self-report improper conduct in advance of a regulatory investigation (taking into account a range of pros and cons) or to impose remedial measures. Companies can use remedial measures both as a sword (by gaining cooperation credit) and a shield (by making recurrence of the underlying misconduct less likely).

Remedial measures to consider include (1) developing new or enhanced policies, procedures, and controls, (2) providing training, (3) restructuring lines of reporting and hiring consultants or additional personnel, (4) reassigning, suspending, or terminating employees, (5) implementing heightened supervision, (6) withholding bonus payments and making additional revisions to equity-based or other compensation, and (7) providing restitution (if possible and appropriate).

## Responding to a preliminary charging determination

At the end of SEC investigations, if the Staff makes a preliminary determination to recommend an enforcement action, they typically will issue a "Wells notice." These notices communicate the Staff's preliminary determination, identify the potential securities law violations, and advise of the opportunity to make a "Wells submission" responding to the charges. The Staff may also provide counsel with an oral briefing of their concerns.

The primary purpose of making a Wells submission is to dissuade the Staff initially, or the SEC Commissioners ultimately, from proceeding with an action or, if this is unsuccessful, to mitigate the charges. These submissions provide an opportunity to lay out the facts in the best light (including correcting any misconceptions on the part of the Staff), show why an action is unwarranted and would be unsuccessful if brought, and identify policy and other considerations militating against an action. When drafting a submission, counsel should be cognizant that the audience is the Staff (including senior enforcement officials, as well as the trial attorneys who would litigate the case) and the Commissioners (who will consider the submission if the Staff decides to proceed with a recommendation).

### Practice Pointer

Wells submissions are not mandatory and, in certain circumstances, are not advisable. For example, if discussions have made it clear that the Staff will not change their mind and there is no possibility of an acceptable settlement, a company may decide to forego a submission. Doing so will avoid revealing the company's positions in advance of contested litigation and protect against potential admissions. In this regard, the Staff takes the position that Wells submissions are admissible as evidence. Significantly, false statements in a Wells submission could be charged as a separate criminal offense.

## The conclusion of the investigation, including settlement and other considerations

Regulatory investigations can conclude in a number of different ways, ranging from no charges to the filing of a contested action. As for SEC investigations, if a decision is made not to pursue charges, Staff policy provides that a closing letter should be issued (although this has not always happened consistently). Other potential outcomes include a (1) deferred prosecution or nonprosecution agreement (see SEC Enforcement Manual, Sections 6.2.3 and 6.2.4), (2) settlement with an agreed-upon action, or (3) contested action filed by the SEC.

If an SEC settlement is contemplated, companies should consider a number of issues, including:

1. Can the company accept the charges being sought by the Staff? Is the Staff willing to reduce harsher charges (for example, scienter-based violations of the antifraud provisions) to lesser charges (for example, process-oriented violations such as nonscienter antifraud, books and records, or internal control violations)?
2. Is the Staff willing to proceed in a forum acceptable to the company, whether as an administrative cease-and-desist proceeding (which includes findings of fact, but generally is considered less severe, has relatively fewer collateral consequences, and does not require court approval) or a civil injunctive action in federal court (which includes only allegations rather than factual findings)?
3. Are the proposed monetary and nonmonetary sanctions acceptable? (The potential sanctions in an SEC action are discussed below.)
4. Will the Staff permit the company to settle without admitting or denying the violations, or will admissions be required? (The Staff recently has started to require admissions in certain cases involving egregious conduct.)
5. Can the company accept the collateral consequences of the action, such as reputational harm, potential consequences

in civil litigation, or disqualifications from certain issuer exemptions under the federal securities regulations (assuming the Staff does not agree to waive such provisions)?

## Practice Pointer

Companies operating in particular industries also might face further consequences. For example, aspects of a settlement might trigger debarment provisions relevant to government contractors.

The SEC can impose a wide range of sanctions in connection with a settled or contested action. The nature of the sanctions will depend on the underlying conduct, as well as the company's response to such conduct (including self-reporting, cooperation, and remediation). Potential sanctions include (1) an injunction or cease-and-desist order, (2) disgorgement of "ill-gotten gains" and related prejudgment interest, (3) penalties ranging up to millions of dollars per incident, (4) barring individuals from serving as officers or directors of public companies, (5) barring accountants or attorneys from appearing or practicing before the SEC, and (6) requiring companies to agree to undertakings (such as the appointment of an independent consultant or monitor).

## Practice Pointer

The SEC requires settling parties to agree not to seek or accept any indemnification or reimbursement (including from insurers) and not to claim, assert, or apply for any tax deduction with respect to penalties paid as part of the settlement. These restrictions typically apply only to penalties, and not to disgorgement or prejudgment interest.

Companies should assess the foregoing factors when deciding whether to resolve an investigation by settlement or to move to litigation. Decisions made during the course of the investigation can position the company and help determine the outcome, including whether the inquiry will conclude without any action being taken, an acceptable settlement will be possible, or litigation will be the only option.

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- Implementing risk-management controls
- Overseeing a succession plan for senior management
- Communicating effectively with shareholders
- Assembling a comprehensive ethics and compliance program

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