Internal Investigations: An Essential Component to Cooperation in an SEC Inquiry

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Judging from a recent string of high-profile settlements, the Securities and Exchange Commission is placing greater importance on corporate cooperation in its investigations, rewarding full cooperation in appropriate circumstances, and more importantly, penalizing the lack of it with steep penalties. While no principle of law requires that a company cooperate in an SEC investigation, well-advised companies often determine that cooperation is in their best legal and financial interests.

Conducting an internal investigation is an essential predicate to establishing good faith cooperation in an SEC inquiry. An effective internal investigation can provide defense counsel with justification to persuade the SEC to reduce the contemplated charges, or to forego filing charges altogether. Six issues to consider in conducting an effective internal investigation are summarized below. The summaries are not meant to substitute for consultation with a qualified securities attorney.

1. Who Will Authorize and Supervise the Investigation

Typically, the company’s board of directors or a committee of the board should authorize and supervise the investigation. This is particularly true if the “targets” of the investigation are company executives. Board members have a fiduciary duty to the company to ensure that it does not engage in unethical or illegal conduct, and must attempt to preserve shareholder value. However, if one of the board members is a suspected target, or if a targeted executive sits on the board, consideration should be...
given to allowing outside counsel to oversee the investigation and to shielding the particular board member or executive from any matters concerning the investigation.

In a recent accounting fraud settlement, SEC v. Del Global Technologies et al., Case No. 04 CV 4092 (S.D.N.Y.), Lit. Release No. 18732 (June 1, 2004), the SEC highlighted the importance of precluding suspected wrongdoers from influencing an internal investigation or intimidating employees. In Del Global, the SEC imposed a significant civil penalty against Del Global Technologies, Inc. (“Del”), in part because Del, upon discovery of the fraudulent accounting scheme by its auditors, commissioned an internal investigation that sought to shield the alleged architect of the fraud, Del’s CEO, from liability. In its litigation release accompanying its complaint, the SEC noted that Del’s Audit Committee hired the CEO’s close personal friend to conduct the investigation, and that during the investigation, the CEO and his associate were permitted to speak to (and intimidate) witnesses prior to their interviews.

2. Should the Company Retain Independent, Outside Counsel?

Absent unusual circumstances or significant financial constraints, it is preferable for a company to retain independent, outside counsel to conduct an investigation, as opposed to using in-house counsel. Outside counsel may bring certain advantages to the investigation, including specific knowledge of securities enforcement laws and white collar criminal laws, and recent investigative and litigation experience. Most importantly, SEC staff typically view independent, outside counsel as more cooperative than in-house counsel. This is particularly true with outside counsel who have formerly worked at the SEC, who may be viewed with less suspicion that an in-house lawyer employed exclusively by company management. This perception of fairness may allow outside counsel to develop a positive working relationship with the SEC staff at the inception of the investigation.

Conversely, SEC staff may view in-house counsel as business advisors rather than legal advisors and may try to obtain their investigative materials on the ground that they constitute business advice, and are not protected by the attorney-client privilege. In addition, in-house counsel may be viewed by company employees as an extension of management, which may cause the employees to be less than candid during interviews, particularly if the employees think their jobs may be at risk.
3. Should the Company Communicate with its Employees about the Investigation?

A company should take active steps to keep employees informed about the SEC’s investigation to mitigate their fears and to prevent potentially damaging rumors from spreading. Employees should be instructed that they should not talk about the investigation to anyone unless counsel is present, and that they should inform counsel if they are contacted by anyone (including the press) for an interview. Furthermore, employees relevant to the investigation should be instructed to cooperate fully with the internal investigation.

4. How Should the Company Coordinate and Conduct Employee Interviews?

Generally, before interviewing senior employees, it may be useful for counsel to interview lower level employees and review background documents. However, when the SEC is conducting an expedited investigation, or when other exigent circumstances exist (i.e., deadlines to file quarterly or annual reports), sometimes there is no time for familiarization – counsel must go directly to the employees with the most knowledge of the pertinent facts.

In an interview, counsel should inform the employee of the general nature of the alleged misconduct under investigation and the status of the SEC’s investigation. Counsel should also inform the employee that counsel represents the company, not the employee, and that the attorney-client privilege belongs solely to the company. In other words, the employee should not necessarily expect that the statements he or she makes during the interview will remain confidential, particularly when the company intends on disclosing the results of its investigation to the SEC.

Many attorneys make it a practice to advise company employees during interviews of their right to have their own counsel. In many instances, particularly for those employees who may be culpable or have interests adverse to the company, it is preferable for the employee to have his or her own counsel. However, in most instances, since the company is a private entity and is not acting as a government agent, the employee has no constitutional right to his or her own counsel during an investigation.

5. How are Documents and Computer Files Maintained?

Using an expansive definition of relevance, a written instruction must be given immediately to all affected employees to preserve all relevant documents and computer files. This is a crucial point: employees respon-
sible for the wrongful conduct may attempt to destroy evidence of their involvement, which will impede the investigation and may raise criminal obstruction of justice concerns. Moreover, if the SEC learns that documents have been intentionally destroyed, the chances of an amicable resolution to the investigation decrease dramatically.

Counsel should immediately direct an employee to locate the most critical documents and files (which should be backed up and protected from viruses), to be placed under counsel’s control. Furthermore, a detailed privilege log should be created and privileged documents should be segregated from other documents to prevent inadvertent disclosure and potential waiver. To preserve the protection of the work product doctrine, employees should also be discouraged from creating any new documents concerning the investigation. New documents should generally be created only by counsel or persons working as his or her agents. In addition, any document prepared during the investigation should note that it is privileged and confidential, protected by the attorney-client privilege and/or attorney work product doctrine, and distributed to the fewest possible people.

6. Should the Company Take Disciplinary and/or Remedial Action?

If an internal investigation reveals that employees have committed wrongdoing, the company should promptly suspend or terminate the responsible employees. The SEC made it clear in Seaboard that “remediation, including dismissing or appropriately disciplining wrongdoers” is a crucial step toward receiving credit for cooperation. Termination may also send a message to the SEC that the company is serious about rectifying past indiscretions.

A company seeking leniency from the SEC must also take remedial action. Remedial action may take several forms, including restating corporate financial statements, compensating investors, instituting new and improved internal controls and procedures, and disposing of members of management present during the wrongdoing, regardless if they are culpable. Of course, if the company’s investigation reveals little or no wrongdoing, the company may rightfully decide to take no disciplinary or remedial action and mount a vigorous defense.

NOTES:

1 See SEC v. Gemstar-TV Guide International, Inc., CV 04-04-4506 (C.D. Cal); SEC Lit. Rel. No. 18760 (June 23, 2004) (penalizing Gemstar $10 million due in part to its “initial lack of effective cooperation or remedial efforts”); SEC v. Symbol Technologies et al., CV 04 2276 (E.D.N.Y),

2 In its Seaboard report issued on October 23, 2001, the SEC set forth four broad criteria that it will consider in evaluating whether to charge a company with violations of the federal securities laws, including whether the company conducted a “thorough review of the nature, extent, origins and consequences of the misconduct.” The SEC also noted that it would consider “the quality and propriety of the investigation into the misconduct, including the expedience and thoroughness of the review, whether the review was conducted by independent persons such as outside directors and legal counsel, and whether there were any limitations placed on those charged with the investigation.” 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, Release No. 34-44969, 76 S.E.C. Docket 220 (Oct. 23, 2001).

3 The attorney-client privilege and work product doctrine are critical issues to consider in an internal investigation. Because they require a comprehensive evaluation far beyond the scope of this article, they are only briefly discussed.