MANAGING A CORPORATE CRISIS

WACHTELL, LIPTON, ROSEN & KATZ

DOCUMENT INDEX **TAB**

Reputational Risk and Crisis Management

by John F. Savarese

In today's climate, securities and financial firms are likely to face the risk of enforcement proceedings that create a situation fraught with potential pitfalls. This section discusses 10 prescriptions for handling these situations well, including the importance of detailed advance planning, management of public statements, cooperation with the government, resisting the urge to discipline early, and, when the smoke clears, learning from the crisis.*

The fallout from the 2008 financial crisis has generated a host of unprecedented challenges for broker-dealer, investment banking, investment advisory, and other financial services firms. The industry sustained a wave of criminal prosecutions, regulatory enforcement proceedings, and parallel private civil actions. In fiscal year 2012, U.S. Attorneys' offices nationwide collected $13.1 billion in criminal and civil actions, and the U.S. Securities and Exchange Commission commenced 734 enforcement actions and obtained more than $3 billion in penalties and disgorgement. Several high-profile matters also triggered congressional hearings, along with massive adverse press attention and publicity.

The securities and financial services industry has been a key focus of government attention. As announced by President Obama in his January 2012 State of the Union address, the U.S. Department of Justice formed the Residential Mortgage-Backed Securities Working Group, consisting of at least 55 DOJ lawyers, analysts, agents, and investigators from across the country. The Working Group is focused on investigating those responsible for misconduct contributing to the financial crisis through the pooling and sale of residential mortgage-backed securities. The unit has already brought at least four enforcement actions, including actions against major financial institutions such as JPMorgan and Credit Suisse.[1] Its focus is said to be on Wall Street firms, big banks, and other entities that the public believes have avoided scrutiny for their role in the housing crisis.[2]

Private equity firms are also an enforcement priority.[3] The SEC's asset management unit is focusing on both "market facing conduct," such as insider trading as well as issues such as calculation of fees and expenses.[4] The ways in which private equity firms value their investments are also attracting the regulators' attention.[5]

The Consumer Financial Protection Bureau, established by Dodd-Frank, is also empowered to regulate financial institutions. Director Richard Cordray has said that while the agency intends to work cooperatively with financial companies whenever possible, he "will not hesitate to use enforcement actions to right a wrong."[6]

Anytime a firm finds itself under any of these sorts of regulatory inquiries, it risks facing a potential corporate crisis, and, for those inclined to look for silver linings within storm clouds, an opportunity. If handled effectively, a firm can emerge from a crisis in one piece, with any flawed procedures and systems corrected, a reputation on the mend, and operations still intact. However, handled poorly, a crisis can leave a firm teetering on the brink of failure, suffering the loss of important customers and personnel, enormous financial costs, and reputational harm. The following are 10 commandments of crisis management that, if implemented effectively, can help a financial services firm wind up at the better end of this range of outcomes.

1 Heed the Boys Scouts' motto: be prepared.

Two levels of preparation are necessary to successfully weather a crisis. The first might best be described as crisis prevention. This involves, among other things, a general review of the adequacy of the firm's compliance and information and control systems. When they function effectively, these systems should reduce the occurrence of unplanned disasters and facilitate the mitigation of the effects of those that can't be prevented.

Every firm should have established standards of conduct in place, and control and information reporting processes that allow management to reasonably conclude

* *Editor's Note:* This section is based on "Handling a Corporate Crisis: The Ten Commandments of Crisis Management," by John F. Savarese, *Banking and Financial Services* 27, No. 7, July 2011, pp. 71-89.

that the firm is operating within the law and under management control.[7] Under the landmark *Caremark* decision, directors have an obligation to satisfy themselves that the company's risk management processes as designed and implemented by management are consistent with the company's corporate strategy and functioning as directed, and that necessary steps are taken to foster a culture of risk-aware and risk-adjusted decision making throughout the organization. Setting the appropriate "tone at the top" and instilling a culture of compliance and "no surprises" are the keys to fostering ethical behavior and minimizing crises brought about by improper or poorly controlled conduct. The U.S. Attorney for the Southern District of New York emphasized that "the best-conceived compliance programs and practices and policies in the world will be too weak to stave off scandal if the core principles are not internalized, if there is not from the top a daily drumbeat for integrity."[8]

Communicating a true commitment to compliance with policies, procedures, and training, and establishing ways for employees to report issues and concerns (e.g., through an employee hot line) can also help prevent a crisis. Often, crises are not really surprises, but are a product of longstanding unethical behavior that had been thus far tolerated by the business leadership and accompanied by rationalizations, such as "everyone does it this way." Proper supervision and the establishment of a mechanism for employees (or even members of the public) to raise concerns about wrongful or questionable conduct can help potential issues surface early and avoid serious problems.[9] In these rapidly changing economic and enforcement environments, all firms should consider whether any enhancements to their policies, procedures, and controls are appropriate.

As discussed more fully later in this report, the second level of preparation involves being ready to effectively deal with a crisis when it arises. In today's business environment, a crisis—particularly for securities and financial firms—may seem almost inevitable. As noted earlier, some can pose a serious threat to a firm's reputation or survival. Investing the time and resources in detailed, advance planning can have a significant impact on how a company weathers a crisis. The considerations set forth in this report should be helpful, but, of course, any advice must be applied thoughtfully, in light of the specific issues raised by the particular matter.

2 While every crisis is unique, advance planning can make a huge difference.

All crises are unique and inevitably raise complex and often unforeseen issues. Thus, there is no single template for a crisis response that will assure that injury will be avoided or minimized. Custom tailoring, not off-the-rack efficiency, is the best prescription. However, there are certain similarities and predictable patterns in the way most crises unfold. Advance planning may give a firm more time to maneuver when a crisis erupts, and more time to focus on the wholly unexpected details.

Preplanning and the exercise of sound judgment are critical.[10] Many crises can be anticipated, at least generally. Rules and strategies should be thought through ahead of time, to the extent possible, for each kind of anticipatable crisis, including, for example: financial fraud or serious accounting problems; criminal or regulatory investigations; significant lawsuits or judgments—e.g., punitive damage awards; discrimination judgments; and failures to comply with legal regulations and/or fiduciary duties.

The first critical step is to establish core crisis teams for each foreseeable type of crisis. The teams should include corporate leadership and high-level representatives from operations and technology, the finance department, media relations, investor relations, the risk and compliance function, and the legal department. Project-specific specialists, such as accountants, should also be included. The company should also have outside counsel who have experience and credibility with regulators and/or prosecutors to handle any internal investigations.

Crisis teams should stay prepared and alert. Once teams are identified, they should meet periodically to assess their readiness to react. The goal is to have a plan that assigns specific roles to each team member in case a crisis occurs. Advisors must be senior enough and experienced enough to deal with the CEO and board effectively. An up-to-date "war list" should be created, with contact information for all key participants.

Firms should take the opportunity to consult with outside counsel and other advisors during "peacetime." It is important to keep an eye on relevant legal and business trends in an effort to anticipate areas of likely crisis. While it may be impossible to predict the actual nature or timing of a crisis, a firm may be better prepared by keeping tabs on applicable legal developments affecting competitors. For example, from time to time, both the SEC and DOJ initiate industry-wide investigations. Recently, it has been reported that DOJ is investigating anti-competitive conduct by cable, satellite, and telecom providers,[11] while the SEC is investigating the film industry in connection with alleged improper payments in China.[12] Both DOJ and the SEC are reportedly focusing on business practices in the medical device industry.[13] In the past, industry-wide investigations have also targeted potential Foreign Corrupt Practices Act violations by

financial firms in connection with their dealings with the Libyan Investment Authority,[14] alleged manipulation in the London Interbank Offered Rate (LIBOR) market,[15] auction rate securities,[16] mortgage foreclosure "robo signing," and mortgage-backed securitization and marketing practices.[17]

The SEC has made clear that more such "sweeps" are on the horizon. For example, when the Commission announced FCPA settlements with Panalpina, Inc. and six other oil services companies alleged to have been engaged in a widespread bribery scheme involving customs officials, the chief of the SEC's FCPA unit noted, "the FCPA Unit will continue to focus on industry-wide sweeps, and no industry is immune from investigation."[18]

As part of their readiness preparation, corporate crisis teams should monitor press reports of actual crises that have affected relevant industries to determine whether and to what extent the same issues may apply to their own firm, and to evaluate how the firm would have responded to a similar problem. For example, high-profile insider trading prosecutions implicating the use of expert networks by hedge funds should trigger a review by comparable firms of their reliance, if any, on such networks.[19]

3 Beginnings are as important as endings.

The outset of a crisis is when proper preparation pays off. Once a crisis actually occurs, the pertinent crisis team can be assembled immediately without losing valuable time. It is critical to quickly get at the facts and find out as much as possible about the situation. Most often, lawyers will oversee the factual investigation. Senior management's grasp of the relevant facts should be quickly assessed by the investigative team. There is often a belief early on that management's knowledge of the facts is clear when it is not. Thus, it is almost always necessary for the lawyers to interview employees at all levels of the company to understand the facts leading up to the crisis.[20]

The firm should focus immediately on document retention and retrieval programs. In any crisis involving regulators and prosecutors, the universe of relevant documents must be quickly identified and preserved. Failure to properly preserve and timely produce documents can result in severe sanctions that may seriously undermine a company's ability to defend itself in court.[21] It will be important for the firm to retrieve documents quickly and efficiently, both to understand the facts and to satisfy external requests for information. It will similarly be important to be able to fully document what steps have been taken.[22] Information technology specialists should be consulted concerning servers, archives, back-up tapes, hard drives, etc. Missteps in document retention and gathering can make a crisis substantially more serious and occasionally can cause more problems than whatever event precipitated the initial crisis.[23]

It is also important to communicate effectively with the board of directors, and, in particular, the audit committee, which may be given principal responsibility for overseeing the handling of such crises. The board should be assured that a team is in place, informed about next steps, and then provided with interim updates as the crisis unfolds. Beware of over-engagement by the board, however. Unless the CEO and senior management team are critically compromised by the nature of the crisis, the board (or whatever committee is delegated oversight responsibility by the board) should be kept advised in a timely way, but should allow management to design and direct a response. While under certain circumstances a committee of the board should be appointed to oversee an investigation and/or "independent counsel" should be brought in, boards should take care not to lose control of the situation to outside lawyers, accountants, and other experts.[24] The proliferation of independent investigations by special committees, each with its own set of advisors, can be distracting and time consuming and, in extreme cases, may result in lawyers for the special committee monopolizing the attention of directors and senior management.

4 Speak with one voice.

Planning ahead for how communications will be handled in the event of a crisis is critical. While numerous constituencies will want to be kept informed during a crisis (e.g., employees, shareholders, trading counterparties, customers, government prosecutors and regulators, and the public), every effort should be made to speak with one voice and to avoid communicating mixed or inconsistent messages. Firms should assess what issues will be of interest to each constituency and craft responses that will reasonably satisfy them that the crisis is being managed properly and that their interests are being protected.

The firm should speak with a single, trained voice via a pre-designated spokesperson or control group authorized to deliver the public message. The firm may want to consider involving public relations professionals early on to set the right tone.[25] Firms should assess the likely effect of a public statement on all stakeholders, especially the government prosecutors and regulators involved, since in a criminal or regulatory investigation they will often be the firm's most important audience.

Firms should expect government attorneys to closely, scrutinize all public statements made on behalf of the company during an investigation, and to be critical of any statements viewed as unduly optimistic or minimizing the significance of the investigation. For example, when Lucent Technologies settled an accounting fraud action with the SEC, the agency imposed an additional $25 million penalty for the company's "lack of cooperation," citing public statements made by Lucent's counsel denying the wrongdoing as one of the factors giving rise to the additional penalties:

> "After reaching an agreement in principle with the staff to settle the case, Lucent's former chairman/CEO and outside counsel agreed to an interview with *Fortune* magazine. During the interview, Lucent's counsel characterized Lucent's fraudulent booking of the $125 million software pool agreement between Lucent and Winstar as a "failure of communication," thus denying that an accounting fraud had occurred. Lucent's statements were made after Lucent had agreed in principle to settle this case without admitting or denying the allegations concerning, among other things, the Winstar transaction. Lucent's public statements undermined both the spirit and letter of its agreement in principle with the staff."[26]

While the firm and/or senior management may wish to appear quickly or immediately knowledgeable and in control, an understanding of the facts will likely evolve over time and may even change dramatically as an internal review progresses. Any initial early statements issued about an investigation should state that senior management is being fully informed and is staying closely involved with the investigation and its resolution. Publicly committing the firm to a definitive position at the outset of an investigation can be treacherous. It is especially risky to deny wrongdoing at an early stage before the firm can be highly confident of the facts supporting that position. Such a denial may not only jeopardize relations with prosecutors and regulators, but can easily undermine the credibility of the firm's internal review and may be viewed by the government as an attempt to mislead the public. The SEC has taken boards of directors to task for public statements found in hindsight to be inadequate.[27] The instinctive "apology" can be equally dangerous. Any premature institutional admission of wrongdoing may be immediately accepted as valid by the government, making it difficult for the firm to backtrack, even if exculpatory facts later emerge. As a result, any ill-considered public statements from the firm about the merits of the matter can seriously threaten the firm's ability to negotiate a favorable disposition with prosecutors and/or regulators.

5 Stop any bad practices as soon as possible.

Any illegal activities should be stopped as soon as the firm learns about them. It is important to promptly address whatever problem seems to be precipitating the crisis.[28] The following is what may be one of the most extreme examples of the consequences that can follow a company's failure to eliminate the wrongful conduct: Stolt-Nielsen was indicted on antitrust and conspiracy charges two years after entering into an amnesty agreement with the DOJ in connection with its role in an international parcel tanker shipping cartel. The DOJ revoked the agreement and indicted the company after it learned from other sources that top Stolt-Nielson executives had continued to participate in the conspiracy for months after the scheme's discovery.[29] The DOJ's initial leniency toward the company was predicated on a number of representations, including that it "took prompt and effective action to terminate its part in the anticompetitive activity."

6 Be careful of the "first date."

Maintaining credibility with regulators and prosecutors is critical. The firm's relationship with regulators does not begin with the onset of a crisis. Long-term investment in a reputation for integrity and compliance can provide a reservoir of good will that may help at a critical time. The goal in preliminary dealings with the government should be a demonstration that the firm and regulator are on the same side: both want to stop any wrongdoing, take corrective steps, and engage in appropriate remediation on a reasonable timetable and within a reasonable budget.

Under the current enforcement regime, in which demonstrations of extraordinary cooperation may be rewarded, consideration must be given to contacting regulators at an early stage. This is essential if the matter will become public, but it is a sound step in many circumstances in any event. The government generally rewards firms for self-reporting and cooperation and may penalize firms for failure to do so.[30] Former Assistant Attorney General Lanny Breuer has noted that the DOJ wants "companies that uncover illegal conduct to come forward voluntarily... if you come forward and fully cooperate with our investigation, you will receive meaningful credit."[31]

For example, the SEC recognized the cooperative efforts of two companies under investigation by agreeing to enter into the SEC's first non-prosecution agreement[32] and its first deferred prosecution agreement.[33] In explaining the decision to accept a non-prosecution agreement from Carter's Inc., rather than bring an enforcement action against the company, the SEC identified the following factors: the "relatively isolated nature" of the unlawful conduct; the company's "prompt and

complete" self-reporting of the misconduct to the SEC; and the company's "exemplary and extensive" cooperation in the inquiry, including undertaking a "thorough and comprehensive" internal investigation.[34]

In its first deferred prosecution agreement with Tenaris, the SEC explained that the company was an "appropriate candidate" because of its "immediate self-reporting, thorough internal investigation, full cooperation with SEC staff, enhanced anti-corruption procedures, and enhanced training." The SEC noted that the "company's response demonstrated high levels of corporate accountability and cooperation."[35]

In 2012 the SEC announced a settlement with Diamondback Capital Management LLC on insider trading charges, which included disgorgement of more than $6 million, a $3 million civil penalty, and an injunction against future violations.[36] The company also entered into a non-prosecution agreement with DOJ prosecutors. The SEC's release noted that in assessing the appropriate remedy, the SEC considered the "substantial cooperation that Diamondback provided, including conducting extensive interviews of its staff, reviewing voluminous communications, analyzing complex trading patterns to determine suspicious trading activity, and presenting the results of its internal investigation to federal investigators."[37]

In determining whether to enter into a non-prosecution agreement, a deferred prosecution agreement, or a conventional settled enforcement action, the factors and considerations that the SEC staff will rely upon are not clear cut. However, based upon the commission's actions to date, it appears that beyond those specifically highlighted in the *Carter's* and *Tenaris* cases, the breadth of any misconduct, the involvement of more senior corporate officers, and a willingness to disgorge all profits from the alleged misconduct will likely be relevant factors.

The SEC also adopted new rules that create financial incentives for whistleblower employees to report suspected securities law violations directly to the commission, which could result in the issuance of subpoenas and thus prompt a potential corporate crisis.[38] Because these rules may encourage employees to circumvent company compliance programs, they may change the dynamics of handling such crises, and companies may feel some pressure to move faster to report possible instances of wrongdoing to the SEC. In addition, the rules create heightened penalties for any retaliation against whistleblowers and possible problems for a company's internal compliance function.

7 You may be able to protect the attorney-client privilege, but you still have to share the key facts.

Under the DOJ's current Principles of Federal Prosecution of Business Organizations, credit for cooperation will not depend on whether a corporation has waived attorney-client privilege or work-product protection, or produced materials covered by attorney-client or work-product protections.[39] The DOJ revised the principles in August 2008 to make significant changes concerning the issuance of cooperation credit. Section 9-28.300 of the U.S. Attorney's Manual continues to provide that prosecutors "should" consider nine factors "in reaching a decision as to the proper treatment of a corporate target," including the corporation's "timely and voluntary disclosure of wrongdoing and its willingness to cooperate in the investigation of its agents." However, the prerequisites for cooperation credit were changed.

The principles now state that credit for cooperation will not depend on whether a corporation has waived attorney-client privilege or work-product protection, or produced materials covered by attorney-client or work-product protections, but rather, will depend on the disclosure of pertinent facts.[40] Corporations that timely disclose relevant facts to the government may receive credit for cooperation regardless of whether they waive privilege in the process. The current policy forbids prosecutors from even asking for non-factual privileged information.[41] Under the prior version of the principles, known as the McNulty memo, prosecutors were permitted to request, under certain circumstances, that a corporation produce non-factual attorney-client privilege communications and work product.[42]

The principles also now specify that federal prosecutors are not to consider whether a corporation has advanced attorneys' fees to its employees, officers, or directors when evaluating cooperation.[43] Under the earlier guidance in the McNulty memo, the DOJ reserved the right to consider such payments negatively in deciding whether to assign cooperation credit to a corporation.[44] Federal prosecutors can also no longer consider whether the corporation entered into a joint defense agreement in evaluating whether to give the corporation credit for cooperating.[45] However, the government has the right to ask that a company refrain from sharing information the government has provided to the company with third parties.

Federal prosecutors should not consider whether a corporation has disciplined or terminated employees for the purpose of evaluating cooperation;[46] they may only consider whether a corporation has disciplined employees it

has identified as culpable, and then only for the purpose of evaluating the corporation's remedial measures or compliance program.[47]

Similarly, the SEC's Enforcement Manual provides that the SEC "staff should not ask a party to waive the attorney-client or work product protection without prior approval of the Director or Deputy Director."[48] The manual makes clear that a party's decision to assert a legitimate claim of privilege should not negatively affect a claim of cooperation credit.

Although the DOJ's and SEC's policies may take waiver of privilege or work-product protection off the table in negotiations, firms facing criminal and regulatory investigations have significant incentives to cooperate fully with government investigators.[49] It is generally in a firm's best interest to seek cooperation credit by providing relevant business records, identifying relevant personnel and evidence, and conveying other pertinent information to government investigators.

8 Not every stone needs to be turned over.

Internal investigations should be designed to uncover the facts relevant to the crisis. Management must know the cause and effects in order to implement appropriate preventative steps. Despite the need to know the relevant facts, not every stone must necessarily be overturned. The nature of the investigation and decisions about who should conduct and oversee it are highly fact-specific. Good management practices suggest that the limits of the investigation should be carefully set and reset, if necessary. The need to move quickly may initially require limiting the scope of the investigation. Due to extensive regulatory overlay in the securities industry, most medium and large firms have built sophisticated in-house legal, compliance, risk management, and audit capabilities, often composed of personnel with substantial law enforcement backgrounds—resources they may be able to rely upon to conduct internal reviews. It is important to stay focused and solve the immediate problem causing the crisis without creating additional problems. Then, consideration can be given to a broader scale compliance audit.

9 Resist the urge to discipline too early.

Firms should tread carefully when determining whether and when to take action against employees involved in a crisis. While they may feel pressure from the press, the public, Congress, and/or the board to move quickly to punish those viewed as responsible, companies should resist the impulse to discipline reflexively. Fairness to employees and officers requires caution here, and frequently coincides with the firm's best interest.

Discipline is often more wisely one of the last steps in an investigation rather than the first in order to ensure that firms do not act prematurely, without full information. Strong discipline may alienate other employees who possess important information and might otherwise be helpful in the investigation. Employee cooperation will be much more difficult to obtain after disciplinary action is taken. Thus, efforts to obtain information should generally be made before any action is taken. The loyalty of a firm to its employees, and vice versa, is a valuable asset that the firm should not squander. Thoughtful judgment is necessary; it is often wise to measure twice or thrice before cutting. The exception is deliberate wrongdoing where the individual personally benefited. If the company's thought process is explained, the government will understand and is not likely to pressure the company into severing all ties with an employee early on. The exception may be when the wrongdoing relates to integrity or misleading the public.

Options for dealing with employees who may be involved in the conduct at issue include: full support for the individual, suspension until the facts are fully developed and informed judgments can be made but with continued financial support in the interim, termination of the individual with fair payment if the misjudgment did not involve a knowing attempt to violate firm policy or the law, or termination without any financial support. Severance and indemnification policies must be considered in making this assessment. Generally, under Delaware law, corporations have the authority to indemnify directors, officers, and others against the costs of threatened or pending legal action, including providing advancement of legal fees.[50] This obligation continues until there is a "final disposition—a final non-appealable conclusion of a proceeding."[51] Securities firms may also have an obligation to disclose any incidents involving employee misconduct under applicable FINRA rules.[52]

The company's expenses in advancing fees may be covered by a directors and officers liability insurance policy. The company should notify its insurance carrier promptly of potential liability to ensure coverage. Counsel for individual directors or for committees of the board might also be well advised to raise the insurance question lest a "notice" issue be created.

10 When the smoke clears, learn from the experience.

Once the crisis has abated, the firm will often need to take steps to repair its reputation with regulators and others, and to restore employee morale. It is also the time to learn from the crisis. The firm's information reporting and control and compliance structures will have been tested and perhaps shown to be wanting.

Therefore, it is prudent for management to review these systems to prevent future problems and to assure the board that such a review is being undertaken.

It is important to ensure that the company's compliance infrastructure is adequate to deal with the current regulatory regime. Altered circumstances require reassessment of legal and compliance issues, relevant practices, applicable policies and procedures, and training programs. As discussed above, a crucial aspect of any compliance program is making clear to employees that management believes compliance is of the highest priority. United States Attorney Preet Bharara stated publicly that executives should never assume that all employees understand the importance of integrity, a basic message he emphasized must be reinforced again and again. He stressed that: "Profound personal integrity, repeatedly demonstrated and openly valued, is absolutely critical."[53]

Periodic risk assessment and reassessment are also critical. The firm must have a strong, well-informed grasp of the financial, reputational, and legal risks in its various lines of regulated businesses and should ensure that a workable early warning system is established. As the business changes, these risk assessments must be refreshed.[54] Employees must understand that the practices of competitors do not justify problematic business activities.

Conclusion

The SEC's Enforcement Manual specifies that one of the relevant factors in assessing whether to open an investigation is whether the case involves a "recidivist."[55] Similarly, the Federal Prosecution Principles provide that "Prosecutors may consider a corporation's history of similar conduct, including prior criminal civil and regulatory enforcement actions against it, in determining whether to bring charges and how best to resolve cases."[56] The firm must be able to assure government prosecutors and regulators that it has learned from past mistakes and has made every effort to build an effective compliance infrastructure, set the right tone at the top, given employees and supervisors adequate tools to understand and comply with applicable rules and regulations, and is committed to following up promptly and vigorously whenever issues surface.

Endnotes

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2 Edward Wyatt and Shaila Dewan, "New Housing Task Force Will Zero in on Wall Street," *New York Times*, January 25, 2012.

3 Laura Kreutzer, "SEC Puts Private Equity Under the Enforcement Microscope," *Wall Street Journal*, January 25, 2012.

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5 Kara Scannell, "SEC to Analyze Private Equity Valuations," *Financial Times*, December 1, 2011; see also *Securities and Exchange Commission,* "SEC Charges Multiple Hedge Fund Managers with Fraud in Inquiry Targeting Suspicious Investment Returns," Press Release, December 1, 2011.

6 Daniel Wagner, "Richard Cordray, Consumer Financial Protection Bureau Director, Touts Enforcement Powers," *Huffington Post*, January 24, 2012.

7 The federal securities laws and Self Regulatory Organization (SRO) rules require financial services firms to implement adequate supervisory systems and controls. See, e.g., NASD Rule 3010, requiring establishment of a supervisory system and adoption of adequate procedures), NASD Rule 3012, requiring firms to test and verify effectiveness of procedures; and FINRA Rule 3013, requiring annual certification by CEO that firm has adequate processes in place. See also *In re Caremark Int'l Inc. Derivative Litig.*, 698 A.2d 959, 970 (Del. Ch. 1996), board of directors has a duty to attempt in good faith to "assure that a corporate information and reporting system, which the board concludes is adequate, exists"; and *Stone ex. Rel. AmSouth Bancorporation v. Ritter*, 911 A.2d 362, 364 (Del. 2006), confirming that *Caremark* set forth the appropriate standard for director liability concerning compliance issues: directors will be liable if there is "a sustained or systematic failure of the board to exercise oversight—such as an utter failure to attempt to assure a reasonable information and reporting system exists."

8 Preet Bharara, Remarks at SIFMA's Compliance & Legal Society Annual Seminar, March 21, 2011; see also Jaclyn Jaeger, "CW 2011: Enforcers Talk Ethics, and Talk Details," *Compliance Week*, June 1, 2011; and Benjamin W. Heineman, Jr., "Goldman Sachs: Being 'Legal' Doesn't Make it 'Right'," *HLS Forum on Corporate Governance and Financial Regulation*, April 27, 2010: "Great companies have to distinguish between what is legal and what is right."

9 Under the Federal Sentencing Guidelines for Organizations, companies that have an "effective compliance and ethics program" may qualify for a reduction in their culpability score: §8C2.5(f). Among the requirements identified in the Guidelines is "to have and publicize a system whereby the company's employees and agents may report…potential or actual criminal conduct without fear of retaliation": §8B2.1. Similarly, the "Principles of Federal Prosecution of Business Organizations" (*U.S. Attorneys' Manual*, §9-28.800), identify as a factor prosecutors should consider whether the directors have established "an information and reporting system in the organization reasonably designed to provide management and directors with timely and accurate information sufficient to allow them to reach an informed decision regarding the organization's compliance with the law." The SEC also considers whether a company has established a mechanism for employee reporting in its evaluation of cooperation. See *Securities and Exchange Commission,* "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," SEC Rel. No. 34-44969, October 23, 2001 (www.sec.gov/litigation/investreport/34-44969.htm). See also Jaclyn Jaeger, "Fraud Reporting Near Record Levels," *Compliance Week*, May 24, 2011, "rise of fraud reporting highlights need for companies to develop mechanisms such as an anonymous reporting channel, allowing fraud to be detected earlier."

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12 Aruna Viswanatha , "SEC Probes Movie Studios Over Dealings in China," *Reuters*, April 24, 2012.

13 Andrew Finkelstein, "Navigating the FCPA within the Medical Device Industry," *Compliance Week*, September 16, 2012.

14 Vaishnavi Bala, "SEC Examining if Goldman-Libya Connection Violated Bribery Laws," *Huffington Post*, August 9, 2011.

15 Carrick Mollenkamp and David Enrich, "Bank Probed in Libor Manipulation Case," *Wall Street Journal*, March 16, 2011.

16 *Securities and Exchange Commission*, "15 Broker-Dealer Firms Settle SEC Charges Involving Volatile Practices in the Auction Rate Securities Market," Press Release, May 31, 2006.

17 *United States Department of Justice*, "Attorney General Eric Holder Delivers Remarks at the Mortgage Services Settlement Press Conference," Press Release, February 9, 2012.

18 *Securities and Exchange Commission*, "SEC Charges Seven Oil Services and Freight Forwarding Companies for Widespread Bribery of Customs Officials," Press Release, November 4, 2010.

19 E.g., Alain Sherter, "Feds Arrest 3 in Insider Trading Sweep," *CBS Money Watch*, January 18, 2012; Charlie Gasparino, "More Charges Coming in Big Insider Trading Probe," *Fox Business*, September 14, 2011; and Evelyn M. Rusli, "Hardball Tactics Against Insider Trading: Next Up: A Crackdown on Outside-Expert Firms," *New York Times*, May 12, 2011.

20 *Upjohn Co. v. United States*, 449 U.S. 383, 386 (1981), "Middle level—and indeed lower level—employees can, by actions within the scope of their employment, embroil the corporation in serious legal difficulties, and it is only natural that these employees would have the relevant information needed by corporate counsel if he is adequately to advise the client with respect to such actual or potential difficulties." Care must be used in conducting such interviews. See, e.g., *U.S. v. Ruehle*, 583 F.3d 600 (9th Cir. 2009), outside lawyers criticized for their failure to clarify exactly whom they represented and to document that appropriate warnings were given. Moreover, in a recent speech, SEC Enforcement Director Khuzami noted that the SEC is concerned about "questionable investigative tactics" by defense counsel, including interviewing multiple witnesses at once, and warned that the SEC would use all the tools at its disposal in situations where counsel's conduct "appears to cross the line from aggressive practice to unethical or obstructive behavior." See Robert S. Khuzami, Remarks to Criminal Law Group of the UJA-Federation of New York, June 1, 2011.

21 Sarbanes-Oxley Act §802 amended the federal criminal code to add 18 U.S.C. §1519, obstruction, alteration, or falsification of records in federal investigations and bankruptcy; and 18 U.S.C. §1520, destruction of corporate audit records. See A. Benjamin Spencer, "The Preservation Obligation: Regulating and Sanctioning Prelitigation Spoliation in Federal Court," *Fordham Law Review* 49, 2011, p. 2005; see also Beryl A. Howell, "The Slippery Slope From Spoliation to Obstruction," *New York Law Journal*, July 27, 2006.

22 E.g., *Voom HD Holdings LLC v. EchoStar Satellite LLC,* 2012 N.Y. Slip Op. 00658 (App. Div. 1st Dep't. Jan. 31, 2012), upholding imposition of sanctions for failure to preserve electronically stored information; see also *Pension Comm. of the Univ. of Montreal Pension Plan v. Banc of America Securities*, 685 F. Supp. 2d 456, 465-66 (S.D.N.Y. 2010), noting that "the failure to issue a written litigation hold constitutes gross negligence because that failure is likely to result in destruction of relevant information" and imposing sanctions where parties' careless collection efforts resulted in loss or destruction of evidence.

23 E.g., *Arthur Andersen LLP v. U.S.*, 544 U.S. 696 (2005), prosecution of accounting firm for obstruction of justice while SEC and DOJ were conducting an accounting fraud investigation aimed at an audit client of the firm; and *United States v. Frank Quattrone*, 441 F.3d 153 (2d Cir. 2006), Quattrone charged with obstruction after documents were destroyed during SEC and regulatory investigations into firm's underwriting of initial public offerings.

24 E.g., *Zapata Corp. v. Maldonado*, 430 A.2d 779 (Del. 1981), Special Litigation Committee composed of disinterested and independent directors can be empowered by the board to evaluate whether the prosecution of derivative claims is in the best interests of the company; and Lawrence J. Fox, *The Special Litigation Committee Investigation: No Undertaking for the Faint of Heart*, Internal Corporate Investigations, 3rd edition, 2007.

25 Communications with public relations professionals, if handled properly, may be protected by the attorney-client privilege. The privilege has been held to protect communications involving third parties when that party is the agent of the client or attorney and is necessary to assist the attorney in the representation: *U.S. v. Kovel*, 296 F.2d 918 (2d Cir. 1961). This doctrine has been held to apply to public relations specialists, among others, in *re Grand Jury Subpoenas*, 265 F. Supp. 2d 321, 327 (S.D.N.Y. 2003), holding that the attorney-client privilege covers communications involving public relations consultant assisting lawyer representing target of criminal inquiry; but see *Calvin Klein Trademark Trust v. Wachner*, 198 F.R.D. 53, 55 (S.D.N.Y. 2000), finding no privilege where PR firm's work simply involved assisting "counsel in assessing the probable public reaction to various strategic alternatives, as opposed to enabling counsel to understand aspects of the client's own communications that could not otherwise be appreciated in the rendering of legal advice." It is critical in any event to properly document the relationship, and establish that the engaged public relations firm's expertise is necessary to assist the law firm in providing legal advice to a company navigating through such a crisis in order to preserve the privilege.

26 *Securities and Exchange Commission,* "Lucent Settles SEC Enforcement Action Charging the Company with $1.1 Billion Accounting Fraud," Press Release, May 17, 2004.

27 *In the Matter of Cooper Companies Inc*., Exchange Act Rel. No. 35082, December 12, 1994, corporate directors have responsibility to safeguard the integrity of a company's public statements; Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934 Concerning the Conduct of Certain Former Officers and Directors of W.R. Grace & Co., Exchange Act Rel. No. 39157, September 30, 1997, (www.sec.gov/litigation/investreport/34-39157.txt), "If an officer or director knows or should know that his or her company's statements concerning particular issues are inadequate or incomplete, he or she has an obligation to correct that failure."

28 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*, SEC Rel. No. 44969 (Oct. 23, 2001), In determining whether to credit a firm for cooperation, SEC will consider, among other things, "What steps did the company take upon hearing of the misconduct? Did the company immediately stop the misconduct?"

29 *U.S. Department of Justice*, "Stolt-Nielsen S.A. Indicted on Customer Allocation, Price Fixing, and Bid Rigging Charges for its Role in an International Parcel Tanker Shipping Cartel," Press Release, September 6, 2006. The company ultimately succeeded in getting the indictment dismissed. See *U.S. v. Stolt-Neilsen S.A*., 524 F. Supp. 2d 609 (E.D. Pa. 2007).

30 *U.S. Attorneys' Manual*, §9-28.700 (The Value of Cooperation); *SEC Enforcement Manual*, §6 (Fostering Cooperation); Robert S. Khuzami, director, SEC Division of Enforcement, *Remarks at News Conference Announcing Enforcement Cooperation Initiative and New Senior Leaders*, January 13, 2010: "For those thinking about cooperating, you should seriously consider contacting the SEC quickly, because the benefits of cooperation will be reserved for

those whose assistance is both timely and necessary...Latecomers rarely will qualify for cooperation credit." The New York District Attorney's Office and FINRA also give companies credit for cooperation. See Daniel R. Alonso, *Memorandum on Considerations in Charging Organizations*, to All Assistant District Attorneys, May 27, 2010, based largely on Principles of Federal Prosecution of Business Organizations; and "FINRA Provides Guidance Regarding Credit for Extraordinary Cooperation," *FINRA Regulatory Notice 08-70*, November 2008.

31 Lanny A. Breuer, Assistant Attorney General, Criminal Division, *Keynote Address at Money Laundering Enforcement Conference*, October 19, 2010; see also Gretchen Morgenson and Louise Story, "As Wall Street Polices Itself, Prosecutors Use Softer Approach," *New York Times*, July 7, 2011.

32 *Securities and Exchange Commission*, "SEC Charges Former Carter's Executive With Fraud and Insider Trading," Press Release, December 20, 2010.

33 *Securities and Exchange Commission*, "Tenaris to Pay $5.4 Million in SEC's First Ever Deferred Prosecution Agreement," Press Release, May 17, 2011.

34 *Securities and Exchange Commission*, "SEC Charges Former Carter's Executive With Fraud and Insider Trading," 2010.

35 *Securities and Exchange Commission*, "SEC Charges Former Carter's Executive With Fraud and Insider Trading," 2010.

36 *Securities and Exchange Commission*, "Diamondback Capital Agrees to Settle Insider Trading Charges," Press Release, January 23, 2012.

37 *Securities and Exchange Commission*, "Diamondback Capital Agrees to Settle Insider Trading Charges," 2012.

38 Implementation of the Whistleblower Provisions of Section 21F of the Securities Exchange Act of 1934, SEC Rel. No. 34-64545, May 25, 2011, (www.sec.gov/rules/final/2011/34-64545.pdf).

39 See "Attorney-Client and Work Product Protections; Cooperation: Disclosing the Relevant Facts," *U.S. Attorneys' Manual*, §9-28.710-20; see also "Waiver of Privilege," *SEC Enforcement Manual* §4.3, "Voluntary disclosure of information need not include a waiver of privilege to be an effective form of cooperation and a party's decision to assert a legitimate privilege will not negatively affect their claim to credit for cooperation."

40 *U.S. Attorneys' Manual*, §9-28.720. The August 2008 revisions represented a significant change in DOJ policy, as compared with the policies reflected in the Thompson memo, issued in January 2003. See Larry D. Thompson, Deputy Attorney General, *Memorandum on Principles of Federal Prosecution of Business Organizations*, January 20, 2003. This change was prompted, at least in part, by the decision in *U.S. v. Stein*, 435 F. Supp. 2d 330 (S.D.N.Y. 2006), *aff'd* 541 F.3d 156 (2d Cir. 2008), which held that the Thompson memo's policy, as implemented by the U.S. Attorney's Office in the Southern District of New York in its investigation of KPMG tax-shelter practices, violated the Fifth and Sixth Amendments. The Thompson memo was then superseded by the "McNulty memo"; see Paul J. McNulty, Deputy Attorney General, *Memorandum on Principles of Federal Prosecution of Business Organizations*, December 12, 2006, (www.justice.gov/dag/speeches/2006/mcnulty_memo.pdf), which was replaced by the current principles now set forth for the first time in the *U.S. Attorneys' Manual*.

41 *U.S. Attorneys' Manual*, §28.720(b).

42 McNulty, *Memorandum on Principles of Federal Prosecution of Business Organizations*, §VII B(2), 2006.

43 "Obstructing the Investigation," *U.S. Attorneys' Manual* §9-28.730, "In evaluating cooperation, however, prosecutors should not take into account whether a corporation is advancing or reimbursing attorneys' fees or providing counsel to employees, officers, or directors under investigation or indictment."

44 McNulty, *Memorandum on Principles of Federal Prosecution of Business Organizations*, §VII B(3), 2006.

45 *U.S. Attorneys' Manual*, §9-28.730.

46 *U.S. Department of Justice*, "Justice Department Revises Charging Guidelines for Prosecuting Corporate Fraud," Press Release, August 28, 2008, "The new guidance provides that prosecutors may not consider whether a corporation has sanctioned or retained culpable employees in evaluating whether to assign cooperation credit to the corporation."

47 "Restitution and Remediation," *U.S. Attorneys' Manual*, §9-28.900(B), "Among the factors prosecutors should consider and weigh are whether the corporation appropriately disciplined wrongdoers, once those employees are identified by the corporation as culpable for the misconduct."

48 *SEC Enforcement Manual*, §4.3.

49 Both Carter's and Tenaris agreed to cooperate in the SEC's continuing investigation as a condition of their settlements: see Deferred Prosecution Agreement, filed December 2010 (www.sec.gov/news/press/2011/2011-112-dpa.pdf); and Non-Prosecution Agreement, filed May 2011 (www.sec.gov/litigation/cooperation/2010/carters1210.pdf). These agreements define cooperation to include, among other things, "producing, in a responsive and prompt manner, all non-privileged documents, information, and other materials to the Commission, as requested by the Division's staff…."

50 Del. Gen. Corp. Law §145, Indemnification of officers, directors, employees and agents; insurance; see also John Mark Zeberkiewicz and Blake Rohrbacher, "The Right Protection: More on Advancement and Indemnification," *The Review of Securities & Commodities Regulation* 41, 2008, pp. 283-288; Richard A. Rossman, Matthew J. Lund, and Kathy K. Lochmann, "A Primer on Advancement of Defense Costs: The Rights and Duties of Officers and Corporations," *University of Detroit Mercy Law Review* 85, 2007, pp. 29-56; and S. Mark Hurd, "Indemnification of Directors and Officers Under Delaware Law," *The Review of Securities & Commodities Regulation* 35, 2002, pp. 262-269. The Second Circuit held in the *Stein* case that action taken by federal prosecutors to pressure the company into denying the advancement of legal fees to its employees was violative of the Sixth Amendment. See 541 F.3d at 136 (2d Cir. 2008).

51 *Sun-Times Media Group Inc. v. Black*, 954 A.2d 380, 136 (Del. Ch. 2008).

52 See Form U-5, "Uniform Termination Notice for Securities Industry Registration," on which the firm is required to report any customer complaint, criminal action, regulatory action, investigation, internal review alleging rule violations, any investigation it may be currently conducting, and the reason for any involuntary termination; see also Susanne Craig and Ben Protess, "Wall Street Often Slow to Disclose Brokers' Sins," *New York Times Dealbook*, February 22, 2011.

53 Preet Bharara, Remarks at SIFMA's Compliance & Legal Society Annual Seminar, March 2011.

54 *Federal Sentencing Guidelines for Organizations*, §8B2.1(c), "In implementing subsection (b), the organization shall periodically assess the risk of criminal conduct and shall take appropriate steps to design, implement, or modify each requirement set forth in subsection (b) to reduce the risk of criminal conduct identified through this process."

55 See *SEC Enforcement Manual*, §2.3.2.

56 See *SEC Enforcement Manual*, §9-28.600.

Recent Developments

SEC Imposes Sanctions for Failure to Protect Customer Information from Insider Data Breach

John F. Savarese. Wayne M. Carlin, Sabastian V. Niles & Marshall L. Miller

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Through a cease-and-desist order and $1 million penalty leveled against a prominent investment adviser last week,[1] the Securities and Exchange Commission flexed newfound muscle in the cybersecurity arena. In the wake of an insider breach by a rogue employee that affected 730,000 customer accounts, the SEC determined that policies and procedures employed by Morgan Stanley Smith Barney LLC (MSSB) failed to sufficiently safeguard customer data from unauthorized access. Following two years of cybersecurity examination sweeps, this enforcement action demonstrates the SEC's resolve to heighten industry focus on cybersecurity.

In December 2014, MSSB's own monitoring discovered customer account data being offered for sale on the Internet. MSSB promptly notified law enforcement authorities and affected customers and took steps to remove the data from the Internet. The ensuing internal investigation revealed that a financial advisor employed by MSSB had, without authorization and in violation of company policy, downloaded customer data, including personally identifiable information (PII) and investment information from 730,000 customer accounts associated with 330,000 households, by circumventing MSSB's database application restrictions. The advisor had transferred the misappropriated data to his personal server, which in turn had been hacked by a third party. The advisor pleaded guilty to federal charges and was sentenced to serve a three-year term of probation and pay restitution of $600,000 to MSSB, the direct victim of the crime.

Rather than treating MSSB as a victim, the SEC accused the company of violating the "Safeguards Rule," which requires broker-dealers and investment advisers to adopt written policies and procedures reasonably designed to safeguard customer records and information from threats that include unauthorized access. The SEC acknowledged that MSSB had adopted controls designed to prevent unauthorized access, including applications restricting employee access to relevant data, but found that the policies and procedures suffered from technical deficiencies, lacked an auditing function, and failed to include systems for monitoring employee access and use. According to the SEC, proper auditing and testing

[1] This memo was originally released June 14, 2016.

would "likely" have revealed the deficiencies. In resolving the action, MSSB neither admitted nor denied the allegations, but agreed to pay a $1 million penalty and to cease and desist from violating the Safeguards Rule.

While the SEC had previously disciplined smaller investment firms that had failed to take the most basic cybersecurity precautions, the MSSB action targeted an industry leader that had implemented significant cybersecurity procedures. With SEC Chair Mary Jo White recently naming a new Senior Advisor for Cybersecurity Policy and describing cybersecurity as "the biggest risk facing the financial system," we can only expect that SEC activity in this area will continue to expand. While the Safeguards Rule applies only to SEC-regulated financial services firms, the case is a reminder to all companies of the need to invest not only in state-of-the-art data protection systems, but also in robust auditing to detect hidden system flaws and monitoring for internal and external breaches alike.

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Handling a Regulatory Investigation in Light of the SEC's Cooperation Guidelines

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Regulatory investigations are now a fact of life for corporate America. While there is no one-size-fits-all approach to addressing regulatory investigations, there are a number of legal and strategic issues that consistently arise. Every company, as part of its crisis management planning, should think through how it will handle an inquiry if and when a regulatory authority comes calling. Although the blueprint for dealing with regulatory inquiries has not varied considerably for many years, companies should periodically refresh their thinking on these recurring legal and strategic issues, particularly in light of the Securities and Exchange Commission's cooperation guidelines (the "Guidelines"),[1] announced by the SEC in 2010.

Set forth in a section of the Commission's Enforcement Manual entitled "Fostering Cooperation," these Guidelines are designed to incentivize individual and corporate cooperation with SEC investigations and enforcement actions. More specifically, the Commission has authorized its enforcement staff to employ various tools, already used regularly and successfully by the Department of Justice in criminal investigations, to encourage individuals and companies to report securities law violations and to provide assistance to the agency. Hailed as "a potential game-changer for the Division of Enforcement,"[2] the Guidelines are meant to improve the quality, quantity, and timeliness of information that the SEC receives. In their first five years, the Guidelines have had a substantial impact on the recommended strategies that corporate counsel pursues when confronted with the possibility or reality of a regulatory investigation.

This article will (1) provide a brief overview of the phases of a regulatory investigation and the key legal and strategic issues that corporate counsel should assess as an investigation progresses; (2) outline the SEC's cooperation Guidelines for individuals and companies and how they have been applied to date; and (3) offer strategic thoughts about the benefits of individual and/or company cooperation under the Guidelines.

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1. Enforcement Manual, Securities and Exchange Commission, Division of Enforcement § 6 at 123, *available at* http://www.sec.gov/divisions/enforce/enforcementmanual.pdf.
2. Robert Khuzami, Director of Enforcement, Securities and Exchange Commission, "Remarks at News Conference Announcing Enforcement Cooperation Initiative and New Senior Leaders" (Jan. 13, 2010), *available at* http://sec.gov/news/speech/2010/spch011310rsk.htm.

OVERVIEW OF A REGULATORY INVESTIGATION

During the course of an investigation, corporate counsel has four overarching goals: first, to proactively manage the company's response to the investigation to cause as little disruption to the business as possible; second, to avoid an enforcement action or, if that is not possible, to minimize the scope and significance of any charge and sanction; third, to minimize adverse or surprise publicity, which may damage the firm's reputation; and fourth, to minimize the investigation's effect on any parallel private litigation.

Initial Considerations

Inquiries come in all shapes and sizes, depending on the particular regulatory authority involved. For example, an SEC enforcement action can begin as a "Matter Under Inquiry" ("MUI"), an informal investigation, or a formal investigation.[3] In the case of an investigation by the Financial Industry Regulation Authority ("FINRA"), the inquiry may vary according to the office from which it originates.[4] In formulating basic responses to an investigation, counsel should consider factors unique to the particular regulator and strive to understand its distinctive investigative process, policies, and procedures.[5]

All inquiries—regardless of the source and regulatory authority—could ultimately result in an enforcement action and therefore should

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3. Even before opening an investigation, members of the SEC staff may open a MUI. Enforcement Manual § 2.3 at 19. According to the Enforcement Manual, "the purpose of a MUI is to gather additional facts to help evaluate whether an investigation would be appropriate." *Id.* § 2.3.1 at 20. MUIs are automatically converted to investigations after sixty days unless closed. *Id.* at 22. An investigation can also be opened independently, either prior to the sixtieth day automatic conversion of a MUI or without any history of a MUI in the case. *Id.* § 2.3.2 at 22.
4. FINRA's home offices, which are located in D.C. and New York, usually handle complex, multi-regional investigations that are self-generated or based on tips, regulatory filings, arbitration claims, or litigation claims. Examination findings, including cycle exams and cause exams, usually serve as the source for investigations by FINRA's regional offices.
5. Of course, there are numerous other regulatory authorities that conduct investigations, such as state attorneys general and state securities regulators, and the nature of the investigation may depend not only on the regulator but also on the source of the inquiry, such as a whistleblower, an anonymous tip, or a news article.

be taken seriously. Regardless of whether counsel believes that wrongdoing has occurred, the company should be responsive to the regulator's requests, and provide information and documents in a prompt and timely manner. An effective initial response may end the inquiry entirely, while a lack of responsiveness can result in a heightened inquiry or full-blown investigation.

After gathering basic information about the regulator and the nature of the inquiry, corporate counsel should consider representation issues. In-house counsel needs to determine whether to handle a matter internally or to retain outside counsel. In larger and more complex matters, or in matters involving senior management, it is generally preferable to retain outside counsel, as outside counsel can provide the necessary resources to handle larger investigations and can help avoid the appearance of a conflict where senior management is the subject of the investigation. In addition, counsel needs to determine whether the same lawyers can represent both the firm and individual employees. When there is no apparent conflict between the interests of the company and individual employees, counsel might choose to represent individual employees to maximize efficiency and facilitate the collection of information. Indeed, it is common practice, and in accordance with the American Bar Association's ("ABA") Ethical Guidelines, for corporate counsel to represent employees within the firm.[6] On the other hand, in situations where the interests of the company and its employees may diverge (for example, where an employee has acted in clear violation of the law and firm policy), separate representation is appropriate. And, as is discussed below, the cooperation guidelines increase the potential for conflicts between the company and individual employees and make these decisions much more difficult. Decisions regarding representation should be re-assessed throughout the investigation process, as new facts and information come to light and negotiations proceed.

6. Association of the Bar of the City of New York, Committee on Professional and Judicial Ethics, Formal Opinion 2004-02, Representing Corporations and their Constituents in the Context of Government Investigations, *available at* http://www.nycbar.org/Publications/reports/show_html.php?rid=240.

Fact Gathering

A first step toward learning the facts often involves initial, informal interviews of employees with knowledge of the matter being investigated. These interviews, which take place during the early days of an investigation and are distinct from the more detailed interviews that occur later in the process, are intended to help counsel understand the key factual issues and identify the roster of relevant individuals.

While getting familiar with the basic facts and key players, counsel needs to identify types and sources of documents relevant to the investigation, including electronic files and backup tapes, and ensure that they are preserved. Counsel should prepare a "litigation hold" or "document hold" notice, which is a memo alerting employees who may have relevant information that they must retain and may not alter, discard, or delete such information.[7] The scope of the document hold notice should be appropriately broad. Counsel can always revise or rescind document hold notices should the investigation turn out to be narrower in scope. On the other hand, documents that have been deleted or destroyed may not be recoverable should the investigation widen beyond the scope of the initial document hold notice. The destruction of relevant documents may carry serious penalties, such as fines and even prison sentences.[8] Moreover, allegations of document destruction can quickly open the door to a criminal referral and destroy the credibility of both the client and counsel.[9]

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7. "It is well established that the duty to preserve evidence arises when a party reasonably anticipates litigation. '[O]nce a party reasonably anticipates litigation, it must suspend its routine document retention/destruction policy and put in place a 'litigation hold' to ensure the preservation of relevant documents.'" *Pension Committee* v. *Banc of America Securities, LLC*, 685 F. Supp. 2d 456, 466 (S.D.N.Y 2010) (citations omitted).
8. For example, Section 802 of the Sarbanes-Oxley Act amended the federal criminal code to add 18 U.S.C. § 1519 (Destruction, alteration, or falsification of records in Federal investigations and bankruptcy) and 18 U.S.C. § 1520 (Destruction of corporate audit records).
9. *See, e.g.*, *Pension Committee*, *supra* note 7, at 465 (imposing sanctions where parties' careless collection efforts resulted in loss or destruction of evidence). In *Maggette* v. *BL Development Corp.*, moreover, a U.S. Magistrate Judge for the Northern District of Mississippi, expressing concern regarding the defendant corporation's apparent failure to fulfill its preservation obligations, ordered the defendant to pay for the services of a third-party e-discovery expert: "[A]

In the beginning stages of an investigation, document subpoenas are often quite broad, as the regulator may not appreciate the breadth of the request or understand with precision the organizational structure or business of the company. It is common, therefore, for counsel to speak with the regulator about narrowing the scope of the initial document requests. In these discussions, it is essential that counsel make clear the distinction between document *preservation* and document *production*. As a general matter, regulators are more likely to agree to narrowing their *production* request than to narrowing their *preservation* expectations. In this vein, counsel needs to communicate with the corporate IT department as well as the relevant lines of business to ensure that the company is complying with its preservation obligations. In addition, counsel needs to continually assess the company's technological and financial ability to retain all the documents required by the regulators. As noted above, a regulator will have little sympathy for a company that claims that it did not have enough money or enough storage space to preserve all relevant information.

Establishing credibility with the regulator is crucial. At the outset and periodically during the course of the investigation, it is helpful to discuss with the regulator the investigation and the client's desire to be cooperative. Communication is important to ensure that counsel's own investigative steps are consistent with the regulator's preferences and instructions. Every communication with the regulator also provides counsel with an opportunity to obtain information regarding the focus of the investigation and to present the client's version of the facts and themes of defense. Counsel's credibility can have a significant impact on the regulator's flexibility during the negotiation of document and testimony requests, so counsel should refrain from making any factual representations without first determining their accuracy.

Perhaps the most important fact-gathering step in the investigation is conducting witness interviews. Interviews usually are most productive after counsel has reviewed relevant documents and taken steps to understand them in the context in which they were created. At the very outset of an interview, it is important that the interviewee understand whom corporate counsel is representing. Specifically, if

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lackadaisical approach to preservation and production of electronic documents is simply unacceptable in today's litigation world." 2009 U.S. Dist. LEXIS 116789, at *4 (N.D. Miss. Nov. 24, 2009).

corporate counsel only represents the corporation, the individual should be advised of that fact. In these circumstances, to the extent the communications during the interview are covered by the attorney-client privilege, the privilege belongs to the company. Counsel should therefore advise individual interviewees that the company may decide to waive its privilege and share the communications with the regulators without consulting the employee.[10]

Regulators may also want to interview employees, either informally or on the record. To prepare the witnesses properly, counsel should speak with the regulators to determine the substantive areas that they are likely to cover during the interviews. Counsel should then review with the witnesses their answers to anticipated questions, ensuring that the witnesses understand the issues and have an opportunity to think about the events so they are prepared to discuss them thoughtfully and honestly. In addition, counsel should spend some time considering which witnesses have the most relevant information and what order of testimony would be most effective in presenting the facts. Though counsel obviously cannot control the regulators' ultimate decision regarding the order in which they speak to witnesses, counsel can sometimes encourage regulators to speak to certain witnesses first and advise them that a particular order of interviews is most likely to answer their questions in an efficient manner. Given the increasing frequency of parallel government investigations involving multiple regulators and law enforcement agencies, counsel should seek to ensure that employees do not testify on multiple occasions about the same matters.

Resolution

Over the course of the investigation, counsel should meet with the regulators to learn their view of the facts and the nature of any potential charges. After an assessment of the issues and the client's potential legal exposure, counsel should begin to consider various resolution options.

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10. *See U.S.* v. *Ruehle*, 583 F.3d 600 (9th Cir. 2009) (holding that corporate executive's statements made to outside counsel hired to conduct internal investigation are not protected by attorney-client privilege, even if executive may not have received proper warning).

Initially, counsel should determine how best to make its case to the regulator that an enforcement action is not appropriate. In some circumstances, a written submission outlining the facts and the absence of any legal violation may be most effective. In others, an oral presentation may be appropriate. Counsel should bear in mind the audience when choosing among various presentation options, including who should attend, who should speak, which documents should be highlighted, and whether visual aids would be beneficial. All of these decisions will impact the success of the presentation, but will vary according to the particular case, client, and regulator.

Establishing realistic goals in negotiations with the regulator is essential. Asking for "too much"—for example, asking the regulator to drop the case where there is clear evidence of wrongdoing, rather than asking for a lesser charge or reduced sanction—may damage counsel's credibility and ultimately do the client more harm than good. In the context of an SEC investigation, these issues might come to the fore upon receipt of a Wells Notice. A Wells Notice is a notification by the SEC staff of its intention to recommend an enforcement action against the recipient. In addition, the Wells Notice informs the individual or entity of the findings made by the staff and offers the recipient an opportunity to submit a writing (known as a Wells Submission) arguing against an enforcement action.[11] Recipients of a Wells Notice may request access to the record and the staff may, in its discretion, allow recipients to "review portions of the investigative file that are not privileged."[12]

SEC COOPERATION GUIDELINES

On January 13, 2010, Robert Khuzami, then-SEC Director of Enforcement, announced a new set of cooperation initiatives for individuals and companies in connection with SEC investigations. In Congressional testimony, former SEC Chairman Mary Schapiro noted that the SEC adopted those measures:

> to encourage corporate insiders and others to come forward with evidence of wrongdoing. These new cooperation initiatives establish incentives for individuals and companies to fully and truthfully cooperate and assist with SEC

11. Enforcement Manual § 2.4 at 28.
12. *Id.* at 30.

> investigations and enforcement actions, and they provide new tools to help investigators develop first-hand evidence to build the strongest possible cases as quickly as possible.[13]

The cooperation Guidelines are contained in a revised version of the SEC's Enforcement Manual, released in January 2010.[14] Section 6 of the Manual—entitled "Fostering Cooperation"—states that "the staff should carefully consider the use of cooperation by individuals and companies to advance its investigations and related enforcement actions."[15] Section 6.1.1 sets forth the framework for evaluating cooperation by individuals.[16] Although the Guidelines note that "the evaluation of cooperation requires a case-by-case analysis,"[17] the Commission's general approach is to determine whether, and how much, cooperation credit is warranted by assessing four considerations: the assistance provided by the cooperating individual in the Commission's investigation or related enforcement actions; the importance of the underlying matter in which the individual cooperated; the societal interest in ensuring that the cooperating individual is held accountable for his or her misconduct; and the appropriateness of cooperation credit based upon the profile of the cooperating individual.[18] The Manual describes in detail precisely how the SEC will assess these factors.

Assistance Provided by Cooperating Individual

When evaluating the assistance provided by an individual and its importance to the investigation, the SEC will consider, among other things, whether the assistance was substantial, whether the cooperation was truthful, complete, and reliable, and whether the individual's involvement saved the government time and money. Significantly, the SEC will also consider whether the individual was the first to report the misconduct or the first to cooperate and whether the

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13. Chairman Mary Schapiro, Testimony Before the Subcommittee on Financial Services and General Government (Apr. 28, 2010), *available at* http://www.sec.gov/news/testimony/2010/ts042810.mls.htm.
14. The original version of the Enforcement Manual was published in October 2008.
15. Enforcement Manual § 6 at 123.
16. This section is also published at 17 C.F.R. § 202.12 as the "Policy Statement of the Securities and Exchange Commission Concerning Cooperation by Individuals in its Investigations and Related Enforcement Actions."
17. Enforcement Manual § 6.1.1 at 124.
18. *Id.* at 123.

cooperation was provided before the individual knew of a pending investigation or related action. The framework therefore places a premium on being the first to report a problem. Indeed, the SEC may limit credit to the first individual who cooperates.

The Commission will also look at whether the individual's cooperation was voluntary or required by some other agreement.[19] In his remarks announcing the Guidelines, Mr. Khuzami reiterated the importance of early cooperation: "And for those thinking about cooperating, you should seriously consider contacting the SEC quickly, because the benefits of cooperation will be reserved for those whose assistance is both timely and necessary. Latecomers rarely will qualify for cooperation credit, so there is every reason to step forward—before someone else does—while you are in a position to benefit from your knowledge of wrongdoing."[20] Current Director of Enforcement Andrew Ceresney reaffirmed recently that "counsel should keep in mind that just as corporate cooperation credit is greatly enhanced by early self-reporting, the same is true with individuals."[21]

Importance of Underlying Matter

The SEC Guidelines explicitly state that "cooperation in [i]nvestigations that involve priority matters or serious, ongoing, or widespread violations will be viewed most favorably."[22] In evaluating the importance of the underlying matter, the Commission will consider the character of the investigation, the number of individuals or entities harmed by the underlying conduct, and the dangers to investors or others presented by the conduct underlying the investigation.

Interest in Holding Individual Accountable

The interest in holding the individual accountable refers to society's interest and focuses on the severity of the misconduct, the individual's culpability, the degree to which the individual took steps to

19. *See id.* at 124-25.
20. "Remarks at News Conference," *supra* note 2.
21. Andrew Ceresney, Director, Division of Enforcement, "The SEC's Cooperation Program: Reflections on Five Years of Experience," Remarks at University of Texas School of Law's Government Enforcement Institute (May 13, 2015), *available at* http://www.sec.gov/news/speech/sec-cooperation-program.html.
22. Enforcement Manual § 6.1.1 at 125.

prevent the misconduct or remedy the harm, and sanctions imposed by other authorities. This factor looks at the severity of the misconduct in light of the individual's education, training, experience, and position of responsibility. A lower-level employee with minimal involvement in the underlying conduct may be more likely to receive significant cooperation credit than a senior executive whose conduct was at the heart of the alleged misconduct.[23]

Profile of Individual

The final criterion is the profile of the individual. This factor analyzes whether it is in the public interest to award credit for cooperation based upon the individual's personal and professional profile. Relevant characteristics include the individual's past history of lawfulness, the degree to which the individual has demonstrated an acceptance of responsibility, and any opportunity to commit future violations in light of the individual's occupation.[24]

In addition to these four factors, the final note to the Guidelines emphasizes the substantial discretion reserved by the SEC, stating that the Commission may not be compelled to consider any of these factors and is free to weigh them as it wishes. The note states:

> Before the Commission evaluates an individual's cooperation, it analyzes the unique facts and circumstances of the case. The above principles are not listed in order of importance nor are they intended to be all-inclusive or to require a specific determination in any particular case. Furthermore, depending upon the facts and circumstances of each case, some of the principles may not be applicable or may deserve greater weight than others. Finally, neither this statement, nor the principles set forth herein creates or recognizes any legally enforceable rights for any person.[25]

Therefore, counsel must keep in mind that even heroic efforts to cooperate do not guarantee any ultimate benefits. In all cases, the Commission retains the sole discretion whether to grant cooperation credit.

In March 2012, the SEC declined to bring an enforcement action against an individual—a senior executive at AXA Rosenberg—based on his "substantial cooperation" and issued a release in an effort to provide some guidance with respect to the circumstances under

23. *See id.* at 125-26.
24. *See id.* at 126-27.
25. *Id.* at 127.

which an individual may receive cooperation credit under the Guidelines.[26] First, the individual provided timely assistance (he was the first to cooperate) and provided truthful, complete, reliable, and detailed information that the SEC was able to use in conducting its investigation. This assistance was provided without any conditions, which enhanced his credibility. Second, the AXA enforcement action involved a high priority area for the enforcement division. Third, the SEC stressed that the executive played a "limited role" in the wrongdoing and that his cooperation facilitated a quick and successful resolution of the action.

Not every cooperator will get a pass, however. In September 2012, the SEC charged Kenneth Wrangell with insider trading.[27] The SEC noted that:

> When contacted by SEC investigators about his suspicious trading, Wrangell promptly offered significant cooperation. He provided truthful details acknowledging his own trading and entered into a cooperation agreement that resulted in direct evidence being quickly developed against Baggett and David. This cooperation enabled the SEC to swiftly reach settlements with all three individuals to recover ill-gotten monetary gains.

Despite his extensive cooperation, Wrangell was still charged with insider trading and required to fully disgorge his profits. As a benefit for cooperating, the SEC reduced the amount of his additional penalty. Recently, in a settled action with a cooperator, the SEC announced it was not imposing any monetary penalty at all, in light of his "extensive cooperation."[28]

FRAMEWORK FOR COOPERATION BY COMPANIES

While the cooperation Guidelines for individuals are relatively new, guidelines for rewarding corporate cooperation have existed for almost a decade. In 2001, the SEC released the so-called "Seaboard Report,"[29]

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26. SEC Press Release, SEC Credits Former AXA Rosenberg Executive for Substantial Cooperation During Investigation (March 19, 2012).
27. SEC Press Release, SEC Charges Three in North Carolina With Insider Trading, (Sept. 12, 2012).
28. *SEC* v. *Frank Tamayo*, Litigation Release No. 23302, SEC Announces Settlement with Cooperator in Grand Central Post-It Notes Insider Trading Case (July 13, 2015).
29. Exchange Act Release No. 34-44969, Securities and Exchange Commission, Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act

which listed the criteria that the Commission considers when evaluating cooperation efforts by companies. In particular, the Manual cites four broad measures of a company's cooperation:[30]

- self-policing prior to the discovery of the misconduct, including establishing effective compliance procedures and an appropriate tone at the top;
- 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 regulatory agencies, and to self-regulatory organizations;
- 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
- cooperation with law enforcement authorities, including providing the Commission staff with all information relevant to the underlying violations and the company's remedial efforts.

The SEC's emphasis on the importance of cooperation is also evident in its January 2006 statement concerning the factors it would consider in determining whether to impose a civil money penalty against a public company.[31] In the Penalty Statement, the Commission set out principles that would guide its imposition of civil penalties against corporations in future actions, including: (1) the presence or absence of a direct benefit to the corporation as a result of the violation; (2) the degree to which the penalty will recompense or further harm the injured shareholders; (3) the need to deter the particular type of offense; (4) the extent of the injury to innocent parties; (5) whether complicity in the violation is widespread throughout the corporation; (6) the level of intent on the part of the perpetrators; (7) the degree of difficulty in detecting the particular type

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of 1934 and Commission Statement on the Relationship of Cooperation to Agency Enforcement Decisions (Oct. 23, 2001), *available at* http://www.sec.gov/litigation/investreport/34-44969.htm.

30. Enforcement Manual § 6.1.2 at 127.
31. Press Release 2006-4, Statement of the Securities and Exchange Commission Concerning Financial Penalties (Jan. 4, 2005), *available at* http://www.sec.gov/news/press/2006-4.htm (the "Penalty Statement").

of offense; (8) the presence or lack of remedial steps by the corporation; and (9) the extent of cooperation with the Commission and other law enforcement agencies.

In a settlement reached with General Re Corporation just a week after the new initiatives were announced, the SEC specifically articulated the factors that earned the company cooperation credit:

> Gen Re's comprehensive, independent review of its operations conducted at the outset of the government's investigations the results of which were shared with investigators; Gen Re's substantial assistance in the governments' successful civil and criminal actions against individuals involved in the scheme with AIG; and Gen Re's internal corporate reforms designed to strengthen oversight of its operations.[32]

In February 2012, the SEC announced charges against four former Credit Suisse investment bankers, but also announced its decision not to bring any charges against the firm.[33] The SEC's press release stressed that under the cooperation initiatives and the *Seaboard* Report, companies can receive real benefits from detecting wrongdoing at an early stage, self-reporting, remediating the wrongdoing, and cooperating with the agency. The release explained that:

> The SEC's decision not to charge Credit Suisse was influenced by several factors, including the isolated nature of the wrongdoing and Credit Suisse's immediate self-reporting to the SEC and other law enforcement agencies as well as prompt public disclosure of corrected financial results. Credit Suisse voluntarily terminated the four investment bankers and implemented enhanced internal controls to prevent a recurrence of the misconduct. Credit Suisse also cooperated vigorously with the SEC's investigation of this matter, providing SEC enforcement officials with timely access to evidence and witnesses.[34]

Similarly, in April 2012, in announcing a settled enforcement action against a Morgan Stanley employee but not the firm itself, the SEC again reaffirmed the continued significance of the *Seaboard* factors:

> Morgan Stanley, which is not charged in the matter, cooperated with the SEC's inquiry and conducted a thorough internal investigation to determine the scope of the improper payments and other misconduct involved.[35]

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32. *SEC* v. *General Re Corporation*, Litigation Release No. 21384 (Jan. 20, 2010), available at http://www.sec.gov/litigation/litreleases/2010/lr21384.htm.
33. SEC Press Release, SEC Charges Former Credit Suisse Investment Bankers in Subprime Bond Pricing Scheme During Credit Crisis (Feb. 1, 2012).
34. *Id.*
35. SEC Press Release, SEC Charges Former Morgan Stanley Executive with FCPA Violations and Investment Advisor Fraud (April 25, 2012).

The SEC also stressed the firm's commitment to its compliance program and the efforts it made to communicate its policies and procedures.

Most recently, the SEC has rewarded companies for their cooperation by significantly reducing the amount of the penalty. Thus for example, in settling FCPA charges against FLIR Systems Inc., the SEC imposed a penalty of $1 million, less than the $7.5 million the company was required to pay in disgorgement, citing the company's self-reporting, cooperation and remedial efforts.[36] Similarly, in another recent FCPA action against Goodyear Tire & Rubber Co., the company was required to pay disgorgement and interest, but no penalty was imposed at all, in view of the company's prompt self-reporting, remedial acts, cooperation and disciplinary actions against employees.[37] Enforcement Director Ceresny has pointed to these two cases as example that Seabord continues to provide a framework under which entities can receive cooperation credit in settlements.[38]

COOPERATION TOOLS

The revised Enforcement Manual introduced five new tools for the SEC to use during investigations in connection with the new cooperation framework: proffer agreements, cooperation agreements, deferred prosecution agreements, non-prosecution agreements, and criminal immunity requests.[39] While DOJ has used them extensively in recent years, these tools were not previously in the SEC's arsenal.[40]

Proffer Agreements

The Guidelines introduced the proffer agreement, which could ultimately induce individuals to provide information to the Commission. Specifically, proffer agreements provide that statements made by individuals may not be used against them in subsequent

36. SEC Press Release, SEC Charges Oregon-Based Defense Contractor with FCPA Violations (April 8, 2015).
37. SEC Press Release, SEC Charges Goodyear with FCPA Violations (Feb 24, 2015).
38. Ceresny, "The SEC's Cooperation Program" *supra*, note 21.
39. Enforcement Manual § 6.2 at 128.
40. As Lanny Breuer, former Assistant Attorney General of the Criminal Division, noted recently, "Over the last decade, DPAs have become a mainstay of white collar criminal law enforcement." Assistant Attorney General Lanny A. Breuer Speaks at the New York City Bar Association (Sept. 13, 2012).

proceedings, except as a source of investigative leads or for impeachment or rebuttal if they testify inconsistently in a subsequent proceeding. With this protection, individuals may be more willing to provide information to the SEC. The Guidelines indicate that the staff should generally require a potential proffering cooperator to make a detailed proffer "before selecting and utilizing other cooperation tools."[41]

The Guidelines also mention a related tool—"oral assurances"—whereby the staff informs an individual or company that the SEC does not anticipate recommending an enforcement action against the individual or company.[42] Where it seems clear that an individual or company has not violated the securities laws, the staff is authorized to assure that person or company that the Enforcement Division does not anticipate recommending any action.

Cooperation Agreements

The Guidelines also introduced cooperation agreements. With a cooperation agreement, the staff agrees to recommend to the Commission that an individual or company receive credit for cooperating in the investigation and may include specific enforcement recommendations. The Guidelines state that the staff should preferably receive proffers before entering into a cooperation agreement. In addition, even in the absence of a cooperation agreement, the staff may take into account an individual or company's cooperation in recommending lesser sanctions or charges or even forgoing enforcement action entirely.[43] In a recent speech, Andrew Ceresney noted that the SEC has signed over 80 cooperation agreements since the Guidelines were adopted.[44]

Deferred Prosecution and Non-Prosecution Agreements

Under the Guidelines, the SEC can also enter into deferred prosecution and non-prosecution agreements. As described in the Manual, the SEC's version of deferred prosecution and non-prosecution agreements appears similar to those frequently used to resolve corporate

41. Enforcement Manual § 6.2.1 at 129.
42. *Id.* at 129-30.
43. *Id*. § 6.2.2 at 130-33.
44. Ceresney, "The SEC's Cooperation Program," *supra,* note 21.

cases in the criminal context. Under the DOJ version of these agreements, individuals or companies normally agree to certain undertakings in exchange for the government's agreement either to defer charges or to not bring them at all. Most significantly, the DOJ version of these agreements typically requires the cooperating individual or corporation to admit, or agree not to contest, certain facts underlying specified offenses. It appears that at least at the beginning, the SEC has looked to DOJ's practice for guidance.

Since the Guidelines were adopted, the SEC has publicly reported its execution of a total of eight deferred prosecution agreements and non-prosecution agreements with entities. In its first deferred prosecution agreement with Tenaris, S.A., the company agreed to pay $5.4 million in disgorgement to resolve an FCPA investigation. In announcing the agreement, then-Enforcement Director Khuzami noted that,

> The company's immediate self-reporting, thorough internal investigation, full cooperation with SEC staff, enhanced anti-corruption procedures, and enhanced training made it an appropriate candidate for the Enforcement Division's first Deferred Prosecution Agreement. Effective enforcement of the securities laws includes acknowledging and providing credit to those who fully and completely support our investigations and who display an exemplary commitment to compliance cooperation and remediation.[45]

The agreement includes a statement of facts that is not binding against Tenaris in other proceedings. Tenaris also agreed to cooperate with the SEC, DOJ and other law enforcement agencies; although the company shared the results of its internal investigation with the government, its continuing cooperation does not require it to waive the attorney-client privilege.

The SEC has since entered into three additional deferred prosecution agreements with corporate entities. The most recent to date is with PBSJ Corporation in connection with FCPA charges.[46] The SEC announced that the company would pay $3.4 million, which "reflects the Company's significant cooperation with the SEC investigation." The release noted, among other things, that after discovering the bribery scheme, "the company self-reported the potential FCPA violations."

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45. SEC Press Release, Tenaris to Pay $5.4 Million in SEC's First-Ever Deferred Prosecution Agreement (May 17, 2011).
46. SEC Press Release, SEC Charges Former Executive at Tampa-Based Engineering Firm with FCPA Violations (January 22, 2015).

In addition, "PBSJ took quick steps to end the misconduct after self-reporting to the SEC, and the company voluntarily made witnesses available for interviews and provided factual chronologies, timelines, internal summaries, and full forensic images to cooperate with the SEC's investigation."

The SEC has entered into four non-prosecution agreements with entities since 2010. It announced its first use of an NPA with Carter's Inc. in December 2010, while simultaneously filing an enforcement action against one of the company's former executives.[47] In explaining its decision to accept a non-prosecution agreement rather than bring an enforcement action against the company, the SEC identified the following factors: (1) the "relatively isolated nature" of the unlawful conduct; (2) the company's "prompt and complete" self-reporting of the misconduct to the SEC; and (3) the company's "exemplary and extensive" cooperation in the inquiry, including undertaking a "thorough and comprehensive" internal investigation.

The isolated nature of the conduct was likely a significant factor in the SEC's determination to use the Carter's case to demonstrate its willingness to address a company's responsibility for the misconduct of a corporate employee through a non-prosecution agreement. While the sales executive had a significant management position, he allegedly acted alone, misled other members of management and pocketed $4.7 million from sales of stock before the company discovered his misconduct.

On April 22, 2013, the SEC announced that it had entered into a non-prosecution agreement with Ralph Lauren Corporation to resolve an investigation under the Foreign Corrupt Practices Act (FCPA).[48] This agreement – the first such agreement in an FCPA case – is another illustration of the potential benefits of cooperation.

The SEC's press release explained that employees of a Ralph Lauren subsidiary bribed government and customs officials in Argentina in order to import the company's products without necessary paperwork and to avoid mandated inspections. In connection

47. SEC Press Release, SEC Charges Former Carter's Executives with Fraud and Insider Trading (Dec. 20, 2010).
48. SEC Press Release, SEC Announces Non-Prosecution Agreement with Ralph Lauren Corporation Involving FCPA Misconduct (April 22, 2013). The press release notes that the company also entered into an NPA with the Justice Department, pursuant to which it agreed to pay an $882,000 penalty.

with the NPA, the company agreed to pay disgorgement in the amount of $593,000 and $141,845.79 in prejudgment interest.

According to the SEC, the company discovered the misconduct during an internal review designed to improve internal controls and compliance efforts, which included FCPA training in Argentina. Within two weeks of the discovery, Ralph Lauren reported the misconduct to the SEC. Thereafter, the company voluntarily and expeditiously produced documents to the SEC. Ralph Lauren provided English translations for documents; provided summaries of witness interviews conducted overseas; and made overseas witnesses available for SEC interviews in the U.S. The company also implemented significant remedial measures, including adopting new training; terminating both the employees involved in the wrongdoing and the related business arrangements; strengthening internal controls and due diligence procedures; and conducting a risk assessment of its operations worldwide. While each case is unique, the SEC's transparency in the Ralph Lauren case provides companies with an indication of the steps that may be sufficient to persuade the SEC to accept a resolution short of an enforcement action.

It bears noting, however, that the overall resolution here, which included an NPA with DOJ, imposed a financial penalty in an amount greater than the company's ill-gotten gains plus interest, and required admissions to facts sufficient to establish liability. While the case is thus a positive step in the SEC's efforts to show that cooperation will be rewarded, the reward may well be viewed as more meaningful if it is offered in a case in which the "exceptional" cooperator is not also making a punitive financial payment and effectively admitting to liability in a parallel proceeding.

The remaining two NPAs involved Fannie Mae and Freddie Mac, resolving the investigation into their disclosures concerning potential exposure to high-risk mortgage loans.[49] In addition to the companies' acceptance of responsibility for their conduct and the agreement not to dispute, contest, or contradict the contents of an agreed-upon statement of facts without admitting or denying liability, the SEC also considered the unique circumstances presented by the companies' status, including the financial support provided to the companies by

49. SEC Press Release, SEC Charges Former Fannie Mae and Freddie Mac Executives with Securities Fraud (Dec. 16, 2011).

the U.S. Treasury, the role of the Federal Housing Finance Agency as conservator of each company, and the costs that may be imposed on U.S. taxpayers.

The factors and considerations that the SEC will rely upon in determining whether to enter into a non-prosecution agreement, a deferred prosecution agreement or a conventional settled enforcement action may continue to evolve. However, based upon the Commission's actions to date, it is apparent that the breadth of any misconduct, the involvement of more senior corporate officers and a willingness to disgorge all profits from the alleged misconduct will likely be relevant factors beyond those specifically highlighted in the cases discussed above.

CONSIDERING THE NEW GUIDELINES IN EACH PHASE OF AN INVESTIGATION

Initial Considerations

While the benefits under the Guidelines seem to be available to all individuals and entities that cooperate with SEC investigations, the SEC will only provide them to those who offer "timely" and "necessary" cooperation.[50] As noted above, those who hesitate in coming forward with information may very well lose the opportunity to cooperate, as the SEC may have obtained the information from other sources.

In considering early cooperation, however, individuals will need to judge whether the risks of coming forward are outweighed by the reasonably likely benefits. For counsel, making these kinds of decisions is often difficult at this early stage of the process, when they are still learning the facts and basic contours of the investigation. Indeed, such a decision is particularly tricky when the risk of a parallel criminal investigation exists. When individuals step forward in an SEC investigation, statements made in connection with a cooperation agreement might be shared with DOJ, potentially impacting or triggering a criminal investigation.

The benefits of cooperating are generally clearer in the criminal context, where the key benefit is avoiding or reducing a term of

50. "Remarks at News Conference," *supra* note 2.

imprisonment, than in the civil context. Prior to the Guidelines, it was the SEC's policy to pursue officer-and-director ("O&D") bars, whereby individuals involved in fraudulent conduct were barred from serving as officers or directors either permanently or for a specified time period.[51] Because it is not clear whether the SEC will refrain from seeking O&D bars in exchange for cooperation, counsel should bear in mind that such bars remain a potential sanction, even if an individual is able to obtain other cooperation benefits, such as a reduced fine.

A corporation's decision to cooperate with an SEC investigation is also not without risk. For example, cooperation may expose the corporate client to additional private civil exposure. Historically, the SEC allowed companies to neither admit nor deny the charges and facts. In 2013, however, the SEC changed this long-standing policy. In certain cases, the SEC may now require admissions of fact when heightened accountability and the acceptance of responsibility are considered to be in the public interest.[52]

Andrew Ceresney has stressed that "In some cases, admissions are beneficial in part because Enforcement staff does not want to sign a defendant up to a cooperation agreement. This might be because we have questions about his credibility on certain issues or because his testimony would not be of great assistance. Still, if a party is settling before trial, it can be useful to us to obtain admissions to make it less likely that party will change his testimony at trial or otherwise testify falsely."[53]

Another issue complicated by the Guidelines is the initial determination of whether company counsel should represent individual employees. As former Enforcement Director Robert Khuzami has noted,

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51. "The role of officers and directors is far too important to allow those with a questionable commitment to the interests of shareholders to serve . . . In today's complex economy and volatile markets, a single, serious breach of the public trust, in my view, undeniably renders one 'substantially unfit' for service as an officer or director." Stephen M. Cutler, Speech by SEC Staff: Remarks at the Glasser LegalWorks 20th Annual Federal Securities Institute (Feb. 15, 2002), *available at* http://www.sec.gov/news/speech/spch538.htm.
52. *See* Chair Mary Jo White, "Deploying the Full Enforcement Arsenal," Council of Institutional Investors Fall Conference (Sept. 26, 2013), *available at* http://www.sec.gov/News/Speech/Detail/Speech/1370539841202.
53. Ceresney, "The SEC's Cooperation Program," *supra,* note 21.

> The SEC's new cooperation program raises the stakes in multiple representation situations. The program….provides for reduced sanctions or even no sanctions, in exchange for truthful and substantial assistance in an SEC investigation. This increases the likelihood that one counsel cannot serve the interests of multiple clients, given the real benefits that could result from cooperation."[54]

If company counsel decide early on to represent multiple persons, they may jeopardize an individual's subsequent ability to cooperate. Company counsel do not want to put themselves in a situation where they also represent an individual who, at some later stage in the investigation, decides to obtain separate counsel and cooperate, only to discover that it is too late to receive any meaningful benefits from the SEC. To avoid this dilemma, counsel should scrutinize early the issue of multiple representations. Of course, assessing potential conflicts of interest is difficult during the early stages of an investigation, when counsel has not developed a full understanding of the relevant issues and facts. Therefore, counsel might consider raising the issue of cooperation directly with individual employees before taking on multiple representations.[55]

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54. Robert S. Khuzami, Remarks to Criminal Law Group of the UJA-Federation of New York (June 1, 2011).
55. When weighing the risks and benefits of cooperation, counsel should also consider the issue of privilege waivers. In 2008, the SEC and DOJ separately issued guidelines regarding the waiver of the attorney-client and work product privileges, both emphasizing that waiver is not a prerequisite for receipt of cooperation credit. Principles of Federal Prosecution of Business Organizations ("Principles"), United States Attorney's Manual §§ 9-28.710, 9-28.720 at 8-12, *available at* http://www.justice.gov/opa/documents/corp-charging-guidelines.pdf; Enforcement Manual § 4.3 at 99-101. The DOJ guidelines now state that "[e]ligibility for cooperation credit is not predicated upon the waiver of attorney-client privilege or work product protection," but rather the "disclosure of the relevant facts concerning . . . [corporate] misconduct." Principles § 9-28.720 at 9. Similarly, Section 4.3 of the SEC's Enforcement Manual states that corporations and individuals will receive cooperation credit if they disclose relevant facts and information, regardless of whether there has been a waiver of privilege, and directs the SEC staff not to "ask a party to waive the attorney-client or work product privileges." Enforcement Manual § 4.3 at 99-100. The Manual explains that "voluntary disclosure of information need not include a waiver of privilege to be an effective form of cooperation and a party's decision to assert a legitimate privilege will not negatively affect their claim to credit for cooperation." *Id.* at 100. Despite these changes, counsel should still consider whether a privilege waiver is necessary or desirable under the particular circumstances of the

Fact Gathering

During the fact gathering stage of the process, the new Guidelines raise additional considerations and concerns for counsel. In criminal investigations, individuals are typically faced with the decision of whether to provide information to the government under the terms of a proffer agreement. While proffer agreements in the criminal context provide individuals with some protection, as they limit the government's ability to use statements made by the proffering individuals, they often inhibit individuals' ability to contest charges later on if the government does not ultimately offer a cooperation agreement. For example, proffer agreements in the Southern District of New York contain many exceptions to the general prohibition against using the proffering witness's statements against him, such as allowing the proffer statements to be offered at trial if the witness, or even his lawyer, make any statements or arguments that are inconsistent with the proffer statements. Under the Guidelines, the precise terms of SEC proffer agreements are unclear and untested. Counsel needs to consider the possibility that, once an individual speaks to the SEC, even under the "protection" of a proffer agreement, that individual's ability to subsequently contest any charges may be greatly limited.

For companies, a heightened concern under the Guidelines is the treatment of employees who decide to cooperate. Common sense dictates that a corporation cannot retaliate against individuals who cooperate and provide information to regulators.[56] At the same time, companies often, upon learning of individual misconduct, want to discipline wrongdoers, both as a matter of good corporate governance and to demonstrate to the regulators that they have taken appropriate action and in no way endorsed unlawful behavior. In grappling with these conflicting concerns, counsel should seek guidance from regulators, making clear that the company is cooperating and not doing anything to interfere with the investigation.

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investigation, such as when otherwise privileged communications reveal that employees acted in good faith.

56. Moreover, Section 922 of the Dodd-Frank Act provides enhanced remedies for whistleblowers who believe they have suffered retaliation by their employers.

Resolution

As noted above, the resolution phase of an investigation may also prove more complicated under the Guidelines, as it is not yet clear what the SEC will require of individuals or companies wishing to take advantage of some of the new cooperation benefits. While the Guidelines obviously provide many new options for resolving regulatory investigations—options that can offer great benefits—there remain many risks and unanswered questions.

For corporations, there is substantial value in the prospect that cooperation may lead to resolutions short of an enforcement action. While time will help clarify the precise circumstances in which the SEC will be willing to offer non-prosecution agreements or deferred prosecution agreements, the availability of these resolutions raises the possibility that companies may see more concrete benefits in return for cooperation.[57]

57. Other regulatory authorities may have their own cooperation guidelines. For example, investigations conducted by FINRA have their own set of cooperation guidelines. *See* Regulatory Notice 08-70. The factors FINRA will consider are: self-reporting violations; extraordinary steps to correct deficient procedures and systems; extraordinary remediation to customers; and providing substantial assistance to FINRA investigations.

NOTES

March 12, 2019

A Reminder About Corporate Crisis Communications

In a case that should serve as a cautionary tale for all public companies responding to a public relations crisis, the DOJ and SEC today announced securities fraud settlements with Lumber Liquidators Holdings, Inc., alleging that the company had made false and misleading statements in response to a damaging report about the company's products aired on the "60 Minutes" television program. The company entered into a Deferred Prosecution Agreement ("DPA") with the DOJ, which included an agreed statement of facts, as well as a cease-and-desist order with the SEC. Lumber Liquidators will pay a total of $33 million in criminal fines, forfeiture and disgorgement.

Lumber Liquidators sells hardwood flooring, which is subject to emissions regulations and testing requirements established by the California Air Resources Board ("CARB"). The company purchased certain of these products from suppliers located in China. The 60 Minutes report alleged that Chinese laminated products sold by Lumber Liquidators contained levels of formaldehyde exceeding CARB standards. The company's share price dropped 20% before the market opened the following day. Lumber Liquidators responded with a press release in which it denied the allegations in the 60 Minutes report and made various affirmative assertions about its compliance efforts. According to the DPA, these statements were false and misleading because the company had recently determined to discontinue using its largest Chinese supplier based on findings by its management that were inconsistent with the public denials. The company was also continuing to sell products from this supplier while seeking a replacement.

This case dramatically illustrates the stakes at issue when companies respond to a crisis. A crisis focused on product issues or other business matters can quickly turn into a securities law problem – and can bring criminal exposure – if public statements are not carefully vetted for accuracy and completeness. These criminal and regulatory dispositions also provide a reminder that all public statements issued in the midst of a corporate crisis will be fly-specked by prosecutors and enforcement attorneys, and the discovery of material errors or omissions will only deepen the company's problems. A thoughtful approach will allow for a rapid and effective response without taking steps that will compound the crisis.

John F. Savarese
David A. Katz
Wayne M. Carlin
David B. Anders
Marshall L. Miller

Effective Crisis Management

Goals of Crisis Management Plan

- If a crisis is handled well, the Company will suffer no lasting damage, with flawed systems and procedures corrected, operations still intact and reputation on the mend
- If handled badly, the Company can suffer enormous financial costs and operational and reputational damage
- Preparation is critical to effectively managing a crisis

Sources of Crisis

Product failure and recall	*Toyota Will Fix or Replace 4 Million Gas Pedals*
Cybersecurity	**Yahoo discloses two largest reported data breaches in history**
PR disasters	**Mylan** ***EpiPen pricing causes outrage***
	Customer dragged off plane; CEO's response widely criticized
Senior employee conduct	**American Apparel: Charney's Bad Behavior Was Very, Very Expensive**
Environmental incidents	**Oil spill threatens Gulf region's ecosystem and fishing, tourism and shipping industries**
Improper business practices	*At Wells Fargo, Complaints About Fraudulent Accounts Since 2005*
Sudden/Unexpected CEO Change	**United CEO resigns in scandal, replacement faces health crisis**
Accounting Problems	**Valeant accounting scandal sees shares drop more than 90%**

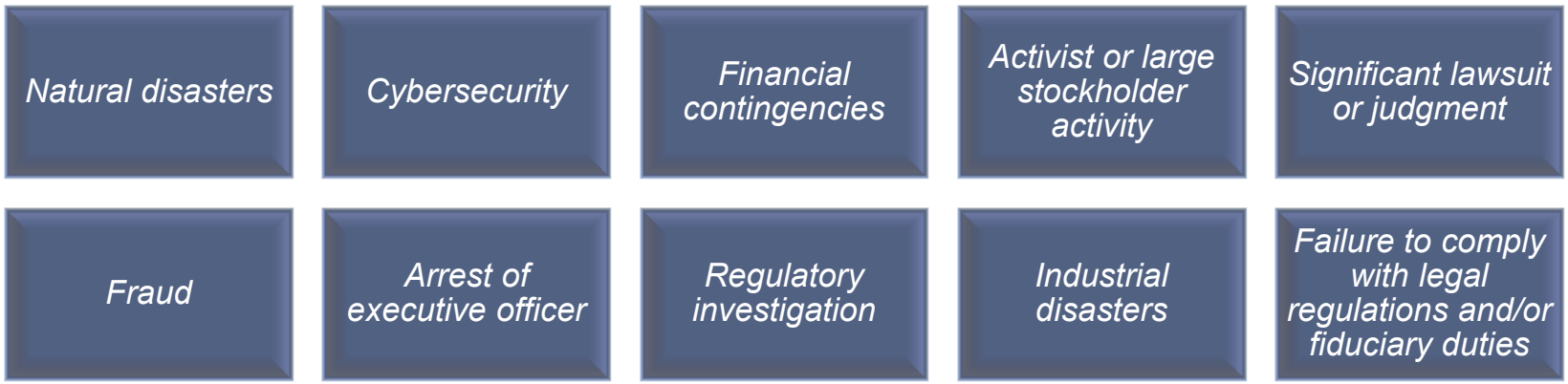
In Advance of a Potential Crisis

- **Advance preparedness is essential**
  - Senior management and Board must be well-informed
  - Officers must be prepared to respond
- **"Risk management" is not just an operational issue, but also a governance priority**
  - Oversight matters, and will help mitigate damage in most crises
  - Boards' duties include an obligation of "oversight" designed to "ensure reasonable reporting and information systems exist that would allow directors to know about and prevent wrongdoing that could cause losses for the Company." *In re Citigroup Inc. S'holder Derivative Litig.*, 964 A.2d 106, 131 (Del. Ch. 2009)
- **Information is power**
  - Culture in which problems are anticipated and recognized in a timely manner
  - Senior management should regularly review:
    - Information, reporting, and control systems
    - Legal profile
    - Shareholder base
    - Financial flexibility
  - Avoid self-inflicted crises
    - Stop any bad practices and/or illegal activities as soon as possible
- **Learn from your competitors—including from their mistakes**
- **Social media has significantly altered the life cycle of a crisis**
  - Dramatically accelerates the pace of a crisis and amplifies any missteps

In Advance of a Potential Crisis

(cont'd)

- Consult with appropriate outside advisors during "peacetime" regarding:
  - Potential threats
  - Legal and financial ability to withstand threats
- No single template fits all crises—but there are predictable patterns in the way most crises unfold
  - Where possible, anticipate each foreseeable type of crisis
  - Custom tailoring is the best prescription



In Advance of a Potential Crisis

(cont'd)

- **Plan ahead for how you will communicate in the case of a crisis**
  - It is often appropriate to refer communications to Chairman/CEO
  - Speak with a single, trained voice
  - Create up-to-date "war list" with 24/7 contact information
- **Establish core crisis teams**
  - Corporate leadership: Chairman/CEO
  - Lead officer
  - General counsel and outside legal advisor
  - Public/investor relations and internal communications
  - Project-specific specialists
    - Involved functions: *e.g.*, marketing
    - Specialist lawyer
    - Accountant
    - Investment banker (not necessary to retain one in advance, but advisable to have someone in mind)
    - Relevant specialist (*e.g.*, cybersecurity technical expert)
- **Consider engaging in tabletop exercises to test crisis response plan**

Case Study: A "Banking Crisis"

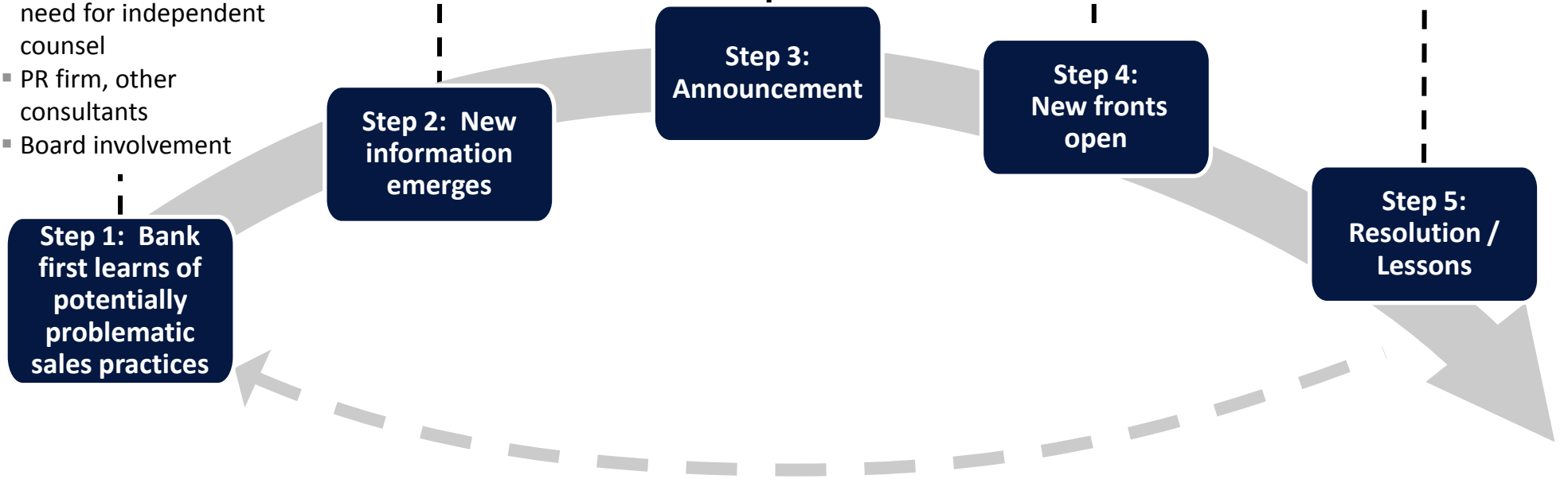
- **Source of potential problem**
  - Self-identified
  - Whistleblower
  - Media reports
  - Subpoena
- **First steps**
  - Stop ongoing harm
  - Remediation
  - Getting on top of facts
  - Internal and external communication
- **Roles**
  - Internal responsibility
  - Outside counsel - should not assume need for independent counsel
  - PR firm, other consultants
  - Board involvement

- **Preemptively dealing with regulators**
  - Self-reporting
  - Cooperation
  - Privilege
- **Managing an internal investigation**
  - Focused but flexible
  - Individual employees
  - Avoid paralysis
- **Internal reporting**
  - Senior management
  - Board

- **Managing the initial public response**
  - Timing
  - Anticipate reactions
  - Solicit perspectives
- **Nature of public statements**
  - Responsiveness v. control
  - Avoid premature commitment to definitive positions

- **Regulatory front may grow**
  - New regulators emerge
  - Congressional inquiries
  - Maintaining credibility
- **Potential civil actions**
  - Customer
  - Employee
  - Shareholder / derivative

- **Resolution**
  - Regulatory resolutions
  - Civil resolutions
- **Rehabilitating reputation**
  - Individual accountability
  - Working with customers, employees, suppliers
  - Engaging shareholders
- **Improving compliance**
  - Reforming culture
  - Actively anticipating future problem areas



Management: Once a Crisis Has Occurred

- **Early response is critical—assemble the right crisis team immediately**
- **Assess senior management's grasp of the relevant facts**
  - Use lawyers to investigate facts, if necessary, but maintain focus on reputational, ethical as well as legal implications
  - Do not assume need to hire "independent" counsel
- **Communicate effectively with the Board of Directors**
  - CEO should assure Board that team is in place and inform as to next steps
  - Appropriate outside directors should be given interim updates
- **Engage openly and actively with key constituencies** (*e.g.*, employees, shareholders, customers/vendors and regulators)
  - But avoid communicating mixed or inconsistent messages; use a pre-designated spokesperson or control group to deliver the public message
  - Note: Congressional testimony can be either an opportunity to start heading in the right direction (e.g., Mary Barra / GM) or a disaster that makes the problem worse
- **Assess the likely effect of a statement on all constituencies, particularly on government prosecutors and regulators**
- **Avoid publicly committing the Company to a definitive position at the outset of an investigation**

Management: Once a Crisis Has Occurred

(cont'd)

- **Maintain control and avoid overreaction**
  - Internal investigations should be designed to uncover the relevant facts
  - Think ahead—one problem often leads to another
  - Analysis, yes, but not paralysis
  - Maintain the right balance between responsiveness and maintaining control
    - You need to stay in the driver's seat as much as possible
- **Remain focused on the issue at hand**
  - Limits to the investigation should be carefully and thoughtfully set and reset if necessary
  - Important to stay focused and solve the immediate problem causing the crisis without creating additional problems
  - After crisis has been contained, consideration can be given to broader scale compliance audit

Management: Once a Crisis Has Occurred

(cont'd)

- **Credibility with regulators and prosecutors is critical**
  - Cultivate a reputation for integrity and compliance
  - Under the current enforcement regime, demonstrations of extraordinary cooperation may be rewarded—consider contacting regulators at an early stage
    - Avoid giving detailed factual explanations until the Company has a firm grasp of the facts
    - Goal is to demonstrate that the Company and regulators are on the same side—both want to stop any wrongdoing, take corrective action and engage in appropriate remediation
- **Guard attorney-client privilege**
  - Under DOJ's Prosecution Principles, cooperation credit does not depend on waiver of privilege
  - SEC's Enforcement Manual also provides that Staff should not ask for waiver of privilege
- **Resist the urge to discipline too early**
  - Impulse to discipline reflexively should be resisted
  - Discipline is often more wisely one of the last steps in an investigation
    - Companies should not act without full information
    - Strong discipline may alienate other employees whose cooperation would be valuable

Recovery: After the Crisis

- **When smoke clears, learn from experience**
  - Openly assess responsibility and accountability
    - Information reporting and control systems
    - Response structures
    - Prevention systems
  - Revitalize, revise and renew key elements of corporate culture and risk management
- **Repair your reputation**
  - In ultimate product markets
  - With customers and suppliers
  - With regulator(s)
  - Take steps to restore employee morale
- **No company is crisis free—you are not alone**

Crisis Preparedness and Management: Cyber & Other Incident Response

Wachtell, Lipton, Rosen & Katz

May 1, 2019

Part I: Preparing for and Responding to a Crisis

Crises Take Many Forms

Improper business practices	Product or supply chain issues
Accounting problems	Activist attacks or hostile takeovers
Sudden/unexpected CEO change or issue	Operational incidents or malfunctions
Senior employee conduct	Big earnings miss, lowered guidance or financial distress
Cybersecurity/privacy breach	Regulatory actions
Public relations disasters	Litigation
Environmental incidents	Workplace violence

Sometimes crises happen in sequence or in combination, one after another

Goals of Crisis Management

- In the short term, the goal of the Board and management of a company facing a major crisis is to ensure the continuity of core business operations
- In the long term, if a crisis is handled well, the Company will emerge in one piece, operations still intact and reputation on the mend, with the opportunity to incorporate "lessons learned"
- If handled badly, the Company can teeter on the brink of failure, lose important clients and partners, and suffer enormous financial costs and reputational damage
- Effective crisis management includes important governance considerations – process and oversight matter – and helps mitigate damage/improve reaction time in most crises
- Preparation is critical to effectively managing a crisis

The Spotlight on Boards

Boards are expected to…

Exercise business judgment and act in a manner they reasonably believe to be in the best interests of the Company and its shareholders

- Oversee Corporate Strategy and Management Communication of Strategy to Investors
- Set Tone for Corporate Culture Prioritizing Ethical Standards, Professionalism, Integrity and Compliance
- Choose CEO and Monitor CEO's and Management's Performance
- Develop Working Partnership with CEO and Management
- **Be Prepared to Deal with Crises**
- Set Appropriate Level of Executive Compensation and Incentive Structures
- Oversee Risk Management and Compliance and Respond to Red Flags When They Arise
- Understand Shareholder Perspectives
- Evaluate Board Performance and Composition
- Determine Thoughtful Board Agendas, Review Corporate Governance and Evaluate Governance Proposals
- Anticipate Possible Activist Attacks
- Take Active Role in Matters Where CEO Has Conflict, as Applicable

Role of the Board in Crisis Management

- **The Board should encourage crisis preparations by the Company and Management:**
  - Be carefully attuned to the risk profile and vulnerabilities of the Company with a view toward anticipating and preparing for potential crises
  - Work with Management to identify key risks and vulnerabilities and understand how Management is allocating responsibilities
  - Liaise with external advisors as needed
  - Ensure that the Company has formed crisis response teams and understand who will do what
  - Regularly review crisis response plan(s) with Management and advisors
- **The Board should understand its role in the Company's response to crises:**
  - Each crisis is different, but in most instances, when a crisis arises, directors are best advised to manage through it as a collegial body working in unison with the CEO and Management team
  - Once a crisis starts to unfold, the Board and the CEO need to be proactive and provide careful guidance and leadership in steering the corporation through the crisis
  - If there is credible evidence of a violation of law or corporate policy, the allegation should be investigated and appropriate responsive actions should be taken
  - The Board, however, should be mindful not to overreact, including by reflexively displacing Management or ceding control to outside lawyers, accountants and other outside consultants
  - Ensure that the Board itself is fully informed and aware of the flow of information
- **In the aftermath of a crisis, the Board should regularly assess with Management the Company's preparedness for future crises and any "lessons learned"**

Preparing for a Crisis

- **Management should establish core crisis teams, develop crisis response plans and define roles and responsibilities in a crisis situation**
  - Corporate leadership: Chairman/CEO (with the Board apprised when escalation is appropriate)
  - Key internal leaders below the CEO
  - General counsel and outside legal advisor
  - Public/investor relations and internal communications
  - Project-specific specialists
    - Involved functions
    - Accountants
    - Industry consultants
    - Financial advisors where relevant (not necessary to retain one in advance, but advisable to have someone in mind)
    - Relevant specialists (*e.g.*, cybersecurity technical experts; environmental specialists)
- **Board and Management should consult with appropriate external advisors during "peacetime"**
  - Potential threats and preparedness
  - Legal and financial capacity to withstand threats
- **Management should develop a communication protocol in the case of a crisis**
  - Speak with a single, trained voice
  - Create up-to-date "team list" with 24/7 contact information
  - Refer any investment and financial community communications to CEO, CFO or the Director of Investor Relations
  - Refer any media communications to the Director of Corporate Communications
  - Refer any M&A-related communications to Chairman/CEO

Preparing for a Crisis *(cont'd)*

- **Advance preparedness is essential**
  - Management and the Board must be well informed
  - Management must be prepared to respond
- **Information is power**
  - Board and Management should create a risk-aware culture in which problems are anticipated and recognized in a timely manner
  - Management should regularly review
    - Information and control systems (at least annually)
    - Legal profile (at least annually)
    - Shareholder base (continuously)
    - Financial and business flexibility (consideration of value-enhancing initiatives)
    - Quality of relationships with key stakeholders (periodically)
    - **What kind of formal and informal early warning systems are in place**
  - Avoid self-inflicted crises
    - Stop any bad practices and/or illegal activities as soon as possible
- **Learn from your competitors—including from their mistakes**
- **No single crisis response plan template fits all crises, but there are predictable patterns in the way most crises unfold**
  - Where possible, anticipate foreseeable kinds of crises
  - Custom tailoring is the best prescription

Responding to a Crisis

- **All external communications should generally flow through the CEO**
- **Individual directors should not speak on behalf of the Company in a one-off way – whether a "Board" response is necessary or appropriate should be carefully thought through**
- **Early response is critical—Management should assemble the right crisis team immediately**
- **Board should stay up to date on new developments and oversee Management's response**
- **Board and Management should assess the Company's grasp of the relevant facts**
  - Investigate facts further, if necessary, including through use of outside consultants
- **Management should regularly brief the Board and relay material information**
  - CEO should confirm for the Board that team is in place and inform the Board as to next steps
  - Key Board leader(s) should be given interim updates as appropriate in between regularly scheduled meetings
  - As needed, special board meetings would be scheduled
- **Management will need to engage openly and actively with key stakeholders** (*e.g.*, employees, shareholders, clients/vendors and regulators)
  - The Company should evaluate the likely effect of a statement on all constituencies, including regulators and potential litigants as well as others
  - Avoid communicating mixed or inconsistent messages
  - Use a pre-designated spokesperson or control group to deliver the public message
- **Be cautious about publicly committing the Company to a definitive position at the outset of a situation, other than confirming the Company takes the matter seriously**
- **Maintain and monitor Company morale**

Responding to a Crisis *(cont'd)*

- **Company should seek to maintain control of the situation and avoid overreaction**
  - Internal investigations should be designed to uncover the relevant facts
  - Think ahead—one problem often leads to another
  - Analysis, yes, but not paralysis
  - Maintain the right balance between responsiveness and maintaining control
    - You need to stay in the driver's seat as much as possible
- **Board and Management should remain focused on the issue at hand**
  - Limits to the investigation should be carefully set and reset if necessary
  - Important to stay focused and solve the immediate problem causing the crisis without creating additional problems
  - After crisis has been contained, consideration can be given to broader scale compliance audit
- **Manage investor reactions and expectations**
  - Vanguard on What Happens When a Crisis Erupts:

    "Most important, we want to see the company respond in a timely and transparent manner. We want to see the board actively engaged in ongoing communications with shareholders as the situation unfolds. Specifically, we want to understand what the board knew and when, how it is responding to the crisis, and what gaps have been identified in its internal board practices that it intends to address. A company's response to a crisis often determines how shareholders vote in the wake of an incident."

Responding to a Crisis *(cont'd)*

- **Credibility with regulators and prosecutors is critical**
  - Cultivate a reputation for integrity and compliance
  - Under the current enforcement regime, demonstrations of extraordinary cooperation may be rewarded—consider contacting regulators at an early stage
    - Avoid giving detailed factual explanations until the Company has a firm grasp of the facts
    - Goal is to demonstrate that the Company and regulators are on the same side—both want to stop any wrongdoing, take corrective action and engage in appropriate remediation
- **Management should guard attorney-client privilege**
  - Under DOJ's Prosecution Principles, cooperation credit does not depend on waiver of privilege
  - SEC's Enforcement Manual also provides that Staff should not ask for waiver of privilege
- **Management should resist the urge to discipline too early**
  - Impulse to discipline reflexively should be resisted
  - Discipline is often, more wisely, one of the last steps in an investigation
    - Companies should not act without full information
    - Strong discipline may alienate other employees whose cooperation would be valuable

Additional Crisis Communication Considerations

- **How do the media and the public perceive your company, industry, team?**
- **How do your customers, employees, legislators, regulators, etc., perceive you?**
- **What will third parties say about you – who are your allies? Who are your critics?**
- **Reiterating the importance of: "This is what we know now/things can change"**
- **Consider range of options for communication mediums and spokespeople**
  - Company spokesperson vs. appropriate senior executive/C-level officer vs. CEO
  - Press release vs. SEC filing (*e.g.*, Form 8-K; 10-Q/10-K) vs. blog posting vs. tweet vs. "microsite"
  - Proactive vs. reactive statements
  - Be mindful of the forum in which you choose to communicate
  - Attempts at humor can be dangerous
- **What is being written in internal documents that might be used (in or out of context) against you?**
  - Leaks
  - Litigation
  - Congress
- **Consider impact on the Brand and how to mitigate impact**
- **Anticipate business partner reactions**
- **Anticipate shareholder and proxy advisory firm reactions**
- **Give clear direction to personnel at all levels in the Company as to how they should or should not respond to inquiries**

Crisis Response: A Real-Life Case Study

Crisis Background

- As of 2015, a public company selling retail flooring products sourced half of its best-selling and most profitable product line from China.
- Warnings to executives and company testing revealed that products from Chinese supplier violated California Air Resources Board ("CARB") regulations governing emissions.
  - Company continued to source flooring products from same supplier, but determined to pursue alternative sourcing in the future.
- In March 2015, *60 Minutes* aired an exposé asserting that the company's products violated CARB emissions regulations, causing >20% stock drop.

Crisis Response

- The company focused on disputing the report's accuracy, rather than ensuring compliance.
- Company press release denied the *60 Minutes* allegations and made various affirmative assertions about compliance efforts.
- Ultimately, after DOJ and SEC investigations, the company conceded that its denials and compliance assertions were materially false and misleading.

Result of Crisis Response

- Company executive leaders, including the CEO, separated from the company.
- In March 2019, the company entered into a DPA with DOJ, consented to a cease-and-desist order from the SEC, and paid $33 million in fines, forfeiture and disgorgement.
- Response deepened the crisis, turning a product issue into a securities law violation.

Recovery: After the Crisis

- **When smoke clears, the Board should work with Management to learn from experience**
  - Openly assess responsibility and accountability
    - Information reporting and control systems
    - Response structures
    - Prevention systems
  - Revitalize, revise and renew key elements of corporate culture and risk management
- **The Company should evaluate ways to address any negative reputational impacts**
  - With client and suppliers
  - With regulator(s)
  - With the investment community and shareholders
  - Take steps to restore employee morale
- **No company is crisis free—you are not alone**

Part II: Responding to a Cyber Crisis

Cybersecurity and Data Privacy: Risk Environment

- Recent data breaches, across a range of industries, demonstrate the continuing challenge of securing company data systems.
  - Recent Herjavec Group study predicts costs of cyber crime will grow to $6 trillion annually by 2021.
- International data privacy laws across the globe are increasing risks of crisis.
  - The EU's General Data Protection Regulation (GDPR) took effect in May 2019; violations can result in fines as high as €20 million or 4% of annual worldwide revenue, whichever is greater.
  - In January, the French data protection authority brought first big GDPR action, fining Google €50 million for violating transparency obligations and consent requirements.
- States are creating and enforcing a complex patchwork of laws, regulations and requirements.
  - California Consumer Privacy Act (CCPA), passed in 2018, will take effect in January 2020.
  - All 50 states have breach notification laws, with varying content, timing and recipient requirements.
  - State attorneys general are aggressively pursuing enforcement actions.
- FTC is reportedly considering levying massive monetary penalty against Facebook.
- SEC has issued warnings regarding market disclosure and internal controls in the wake of a breach.
  - Public companies must disclose material cyber incidents and risks, with the SEC's Division of Corporation Finance monitoring cyber disclosures.
  - SEC has warned that insider trading and Reg FD policies must operate effectively post-breach.
- U.S. Congress and a dozen states are considering data privacy legislation.

Spotlight on Business Email Compromise

- Cyber criminals are increasingly using social engineering tactics to engage in phishing campaigns targeting company employees.
- An increasingly prevalent scheme: Business Email Compromise.
  - Cyber criminals impersonate company executives or company vendors and send emails to finance personnel requesting wire transfers.
  - FBI estimates >$5 billion in losses from Business Email Compromise since 2013.
  - Can have follow-on impact, such as responsive emails containing sensitive info.
- In October 2018, the SEC issued an investigative report assessing adequacy of internal controls at nine public companies victimized by Business Email Compromise schemes.
  - Nine companies transferred a total of nearly $100 million to cyber criminals.
  - Investigation identified control weaknesses, compounded by company personnel circumventing existing controls or acting beyond their authority.
  - The SEC determined not to pursue any enforcement action, but emphasized that failure to account for cyber-related risks in devising and maintaining internal accounting controls may violate federal securities laws.
  - Report places public companies on notice.

The Many Shapes of a Cyber Crisis

- Cyber incidents have caused corporate crises that vary in nature, including:
  - Compromise of customers' Personal Identifying Information;
  - Loss of highly sensitive intellectual property and other 'crown jewel' data;
  - Investigations and enforcement actions threatening fines, monitors and remedial requirements;
  - Civil lawsuits, including class actions, derivative suits and claims by affected individuals and entities;
  - Congressional or other legislative inquiries, triggering testimony of corporate executives;
  - Criminal indictment of employees who trade on breach-related inside information;
  - Forced departure of key corporate executives;
  - Shareholder and proxy activity, including withhold campaigns; and
  - Drop in stock prices, in both short and long term.
- Cyber crises in 2018 highlighted key issues:
  - Marriott breach, involving personal data of >380 million Starwood guests, began in 2014, two years before acquisition.
  - Cascade of Facebook incidents, including data breach revelation, privacy investigations, Cambridge Analytica activity, and Congressional inquiries.

Case Study: Marriott Data Breach

- In November 2018, Marriott International disclosed a breach of its Starwood guest reservation database.
- A security tool alerted on September 7, 2018; subsequent investigation revealed evidence of unauthorized access to company networks since July 2014.
  - On November 19, 2018, the investigation determined that the Starwood database had been breached.
- The breach exposed personal information of up to 383 million Starwood guests.
  - Compromised data included approximately 18.5 million encrypted passport numbers, 5.25 million unencrypted passport numbers, 9.1 million encrypted payment card numbers and potentially several thousand unencrypted payment card numbers.
  - Marriott could not "rule out" the possibility that hackers stole the decryption keys.
- Marriott announced the breach in a press release and 8-K on November 30, 2018.
  - The CEO expressed "regret," the company reported engaging security experts and notifying law enforcement, and it implemented a dedicated website, a call center and email notifications.
  - The company offered identity monitoring services and replacement passports for affected guests.
- Post-breach, Marriott has experienced numerous lawsuits and investigations.
  - Marriott notified regulators in >20 countries, as well as state AGs, the FTC and the SEC.
  - Approximately 100 putative class action lawsuits have been filed, which have been consolidated into an MDL in the District of Maryland, as well as a shareholder derivative suit.
  - Federal, state, and international authorities are investigating, including AGs from all 50 states, the FTC, the SEC, congressional committees, and the UK data protection authority.
  - The CEO testified before a U.S. Senate committee in March 2019.

Cyber Crisis: Anatomy of a Response

- Preparation
  - Intrusion/breach detection capabilities
    - Security Operations Center, operating 24/7
  - Cyber incident response and business continuity plans
    - Identification of incident response team members
    - Incident classification/elevation procedures, with secure communication protocols
    - Retention of key advisors – technical, legal, PR/IR
  - Backup of key company data and emergency network capabilities
  - Relationships with key regulators and law enforcement actors
  - Training and tabletop exercises to drill incident response plan
- Immediate Response
  - Execution of incident response plan
    - Identification and classification of incident
    - Deployment of incident response team, including necessary external advisors
    - Elevation/internal notification of incident
  - Commencement of incident investigation – scope, nature, impact, source
    - Maintain logs, preserve evidence, protect privilege
  - Initial remedial steps to terminate incident, contain damage

Cyber Crisis: Anatomy of a Response *(cont'd)*

- Response and Remediation
  - Continuation of incident investigation, containment of impact
  - Remediation of key vulnerabilities
  - Key notification determinations
    - Impacted individuals/entities – consideration of breach notification laws, contracts
    - Regulatory/law enforcement agencies
    - Market disclosure
    - Insurance providers
  - Media/PR/IR strategy deployment
  - Application of insider trading/Regulation FD policies
  - Attention to continuity of operations
- Recovery
  - Mitigation/eradication of effects of incident
  - Continued attention to notification/disclosure responsibilities
  - Protective measures to harden defenses, enhance resilience
  - After-action assessment of performance of cybersecurity systems, including incident response

Key Judgments in a Cyber-Related Crisis

- **Preparation**
  - What cyber incidents should trigger implementation of the response plan?
  - Who, internally, should be responsible for developing and executing the plan?
  - Who, internally, should be responsible for each aspect of plan implementation?
  - What response technology and services should be in place, pre-incident?
  - What steps can be taken to ensure continuity of operations?
  - How can the risk of legal liability be minimized?
  - How should the response plan be tested?
  - How should C-level management and the Board of Directors be engaged as part of preparedness?
- **Response**
  - How quickly can the source, nature and scope of the intrusion be determined?
  - How and when should the company engage the Board of Directors?
  - Are outside counsel or other experts required to investigate and remediate?
  - Should the company "hack-back" or otherwise offensively respond?
  - Should the company contact law enforcement or regulators? If so, when and how?
  - Should the company reveal the breach publicly? If so, when and how?
  - How should the company communicate with affected customers and third parties?
  - What can the company learn from the incident?

Successful cyber incident response appears instantaneous, but results from extensive pre-incident planning

Part III: Responding to a White-Collar Crisis

Case Study: A White-Collar Crisis

- **Source of potential problem**
  - Self-identified
  - Whistleblower
  - Media reports
  - Subpoena
- **First steps**
  - Stop ongoing harm
  - Document hold
  - Initial remediation
  - Getting on top of facts
  - Internal and external communication
- **Roles**
  - Internal responsibility
  - Outside counsel — don't assume need for independent counsel
  - PR firm, other consultants
  - Board involvement

- **Dealing with regulators**
  - Self-reporting determination
  - Cooperation
  - Privilege
- **Managing an internal investigation**
  - Focused but flexible
  - Individual employees
  - Avoid paralysis
- **Internal reporting**
  - Senior management
  - Board
- **Dealing with external auditors**
  - Investigative oversight
  - Privilege

- **Managing the initial public response**
  - Timing
  - Anticipate reactions
  - Solicit perspectives
- **Nature of public statements**
  - Responsiveness v. control
  - Avoid premature commitment to definitive positions

- **Regulatory front may grow**
  - New regulators and law enforcement actors emerge
  - Congressional inquiries
  - Maintaining consistency and credibility
- **Potential civil actions**
  - Client
  - Employee
  - Shareholder/derivative
  - Production and privilege issues

- **Resolution**
  - Law enforcement resolutions
  - Regulatory resolutions
  - Civil resolutions
- **Handling remediation**
  - Discipline
  - Compensation
- **Rehabilitating reputation**
  - Individual accountability
  - Working with clients, employees, suppliers
  - Engaging shareholders
- **Improving compliance**
  - Reforming culture
  - Actively anticipating future problem areas