Hot Topics Facing Directors of Public Companies

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"Hot Topics" for Public Companies

- Today's focus will be on best practices for directors of public companies, in light of recent developments in the law and current SEC Enforcement initiatives.
- Our discussion will include:
  - The importance of establishing the "Tone At The Top"
  - Understanding SEC enforcement priorities
  - Dealing with whistleblower complaints under the Dodd-Frank Act
  - Understanding the impact of the Foreign Corrupt Practices Act
  - Structuring internal investigations to minimize litigation risk
  - To self-report to government regulators or not?
  - Auditor standards for investigating possible "illegal acts"

Starting Point – "Culture of Compliance"

- As a starting point, it is important to understand what the SEC and other outside regulators expect from public companies and their Boards of Directors – that is, a commitment to a "Culture of Compliance."
- Speech by Lori Richards, SEC Director, Office of Compliance – 10/18/02:
  - "What is a Culture of Compliance? We at the SEC have often talked about the need to instill a strong Culture of Compliance within firms – this means establishing, from the top of the organization down, an overall environment that fosters ethical behavior and decision-making. Simply put, it means instilling in every employee an obligation to do what's right. This culture will underpin all that the firm does, and must be part of the essential ethos of the firm …"
- Speech by Stephen Cohen, Associate Director of Enforcement – 10/17/03:
  - "As I discuss the many ways that the SEC's efforts support compliance and ethics programs, I fully appreciate that you all are on the front lines in the battle to persuade companies to invest in your profession. You need to be armed with the knowledge of how law enforcement and regulatory agencies value the genuine efforts undertaken by companies to generate a culture of integrity and respect for the law. We care and we give credit for those efforts."

The SEC Enforcement Process

- SEC reliance on whistleblowers – recent trends
- SEC enforcement priorities, including:
  - Insider trading
  - Financial fraud and accounting irregularities
  - Foreign Corrupt Practices Act (FCPA) violations
- Hot Topic: Self-reporting and credit for cooperation

Whistleblower Complaints Under Dodd-Frank Act

- Dodd-Frank Act of 2010 contains sweeping changes to claims by whistleblowers.
- Increased monetary incentives for whistleblowers – individuals may recover double back pay and up to 30% of monetary sanctions obtained by the government over $1 million.
- Bypasses prior administrative process by encouraging individuals to go directly to the SEC; individuals also can bring suit directly in Federal Court for discrimination claims.
- SEC Whistleblower Awards
  - First award made in August 2012 for approx. $50K and recently increased to $200K
  - Largest award to date = $14 million

Responding to Whistleblower Complaints – Best Practices

- In response to the whistleblower provisions of Dodd-Frank, companies are encouraged to:
  - Educate employees on compliance programs and encourage employees to utilize internal reporting systems
  - Develop policies relating to management's response to whistleblower reporting
  - Ensure that strong anti-retaliation policies are in place and enforced
  - Move promptly to investigate whistleblower complaints
  - Maintain sufficient documentation regarding response to the allegations
  - Invest in training and build infrastructure needed to ensure compliance with the Act

Claims Arising Under the FCPA

- **Enforcement of the FCPA**
  - DOJ and SEC share jurisdiction for investigations and enforcement actions.
    - See March 31, 2014 speech by Mary Jo White, SEC Chair – "*All-Encompassing Enforcement: The Robust Use of Civil and Criminal Actions to Police the Markets*"
  - DOJ maintains jurisdiction over all criminal investigations and prosecutions.
  - Criminal penalties for each violation of the anti-bribery provisions: $2 million fine for companies, $100,000 fine for individuals, or twice the amount of improper gain or loss (if higher); 5 years imprisonment.
  - Criminal penalties for each willful violation of the books and records provisions: up to $25 million fine for companies and $5 million fine for individuals; 20 years imprisonment.
  - Potential debarment (suspension of right to do business with the U.S. government).

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"Red Flags" for FCPA Compliance

- **"Red Flags"**
  - Business in countries with a history of FCPA problems — *e.g.*, China, India, Mexico, Ukraine, Venezuela.
  - Request for payment in cash, or indirect payment, or payment to offshore account.
  - Request to retain third-party intermediaries.
  - Request for payment in amount far exceeding reasonable compensation.
  - Apparent lack of appropriate training, education, or experience.
  - Agent recommended by foreign official.
  - Request for reimbursement with incomplete documentation.
  - Emphasis on local/familial "connections."

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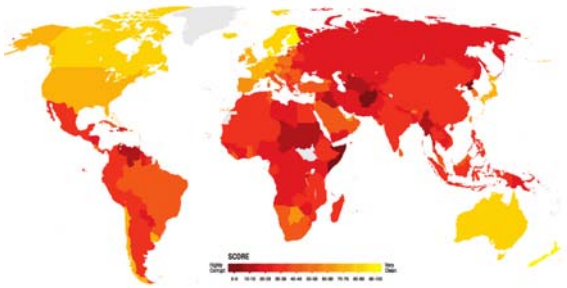
Where Do You Have FCPA Risk?



Source: Transparency International "*2013 Corruption Perceptions Index*"

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Responding to Reports of FCPA Violations or Other Possible "Illegal Acts"

- Senior management, in consultation with Board of Directors, will need to determine:
  - whether an investigation should be conducted,
  - who will conduct the investigation,
  - how factual information will be developed, and
  - how the investigation will ultimately be reported.
- The Audit Committee of the Company's Board of Directors should be advised of allegations of financial impropriety or serious misconduct by senior management.

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Role of Board of Directors

- What Directors need to know at the start of an investigation:
  - Statement of their obligations (to discharge fiduciary duties and avoid personal liability)
  - Clear guidance on how to conduct investigation and what to do with the results – a road-map of what is likely to occur
  - Understand broader implications – disclosure to shareholders; assessment of management integrity; working with outside auditors; dealings with federal and state regulators
  - Understanding of indemnification/insurance: both individual and entity

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Structuring the Investigation

- A threshold determination must be made as to how best to structure the investigation for purposes of internal oversight and control.
- Options available generally include:
  - Oversight by General Counsel or CEO/CFO, with report to Board of Directors
  - Oversight by full Board of Directors
  - Delegation to Special Committee of Board
  - Delegation to Audit Committee

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Report Out of Investigative Findings

- From the outset of the investigative process, consideration should be given up-front as to how the results of the investigation will ultimately be disclosed, and to whom.
- Options generally available include:
  - Disclosure limited to Board of Directors and senior management;
  - Disclosure to SEC, and other governmental regulators;
  - Disclosure to company's stockholders, debtholders and general public.

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The Disclosure Decision

- Absent an affirmative duty of disclosure under the federal securities laws, or other legal mandate, there generally is no duty to disclose the commencement of an internal investigation or the receipt of an investigative inquiry or subpoena from the SEC or other governmental agency.
- Nevertheless, senior management and/or the Board of Directors may decide as a matter of policy to disclose the existence and/or results of the internal investigation or SEC inquiry.
- A decision to "self-report" to the SEC or DOJ raises a variety of complex and nuanced issues, including whether the company is prepared to update its disclosure as the investigation proceeds and the real world benefits of cooperating in resolving a government enforcement action.

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If Not Mandatory, How to Decide to Disclose and to Whom

- Constituencies
  - SEC and other regulators
  - Criminal authorities – DOJ/AG
  - Shareholders, customers, vendors
- There are a number of "voluntary" disclosure programs as agency guidelines
  - IRS Voluntary Disclosure Program
  - State Department – ARMS Export Control Act
  - DOJ Antitrust Amnesty Program
  - DOJ/DOD – Defense Voluntary Disclosure Program
  - FCA Mitigation Provision

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What Are You Trying to Accomplish With Disclosure?

- Provide material information to shareholders
- Comply with obligations under federal securities laws
- Engage with federal and state regulators in cooperative manner
- Avoid government enforcement action
- Mitigate penalties for misconduct
- Influence the portrayal of any misconduct

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What Are the Risks of Self-Reporting and Public Disclosure?

- Potential loss of control over investigative process
- Delay in closing out investigation, with completion of process highly dependent on SEC and/or DOJ sign-off
- Ongoing debate over credit provided for cooperation by federal regulators
- Parallel litigation – potential to invite securities class action complaints and shareholder derivative demand
- Potential for attorney-client/work product waiver
- General business disruption and legal expense

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SEC Section 10A – Possible Illegal Acts

- Requirements and triggers for auditor involvement
- Initial audit team considerations
  - What is an "illegal act"?
  - When is an act considered "clearly inconsequential"
  - Who from management is involved? Does it include someone the auditors are taking representations from?
- Audit Committee notification & preliminary assessment

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SEC Section 10A – Possible Illegal Acts

- Investigation Considerations
  - Are the investigators qualified and independent?
  - Is the scope of the investigation adequate and reasonable?
- Access to the investigation details and investigator's conclusions
- Adequacy of remediation
  - Scheme participants
  - Control environment
- Additional expectations

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