

**THE SEC'S NEW COOPERATION GUIDELINES –
PROGRESS, AND SOME POSSIBLE PITFALLS**

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Over the years, SEC Commissioners and staff have given many a speech that talked in general terms about the virtues of cooperation with the Commission's full-disclosure and law enforcement missions. In a recent Section 21(a) Report (Exchange Act Rel. No. 44969, AAER No. 1470 (Oct. 23, 2001)), the SEC seems – for the first time since the illegal payments investigations of the late 1970s – to be prepared to do something about the issue by outlining in relatively precise terms what it means when it speaks of “cooperation” by publicly-traded issuers, and what an issuer may hope to gain by doing so. We believe that the 21(a) Report is an excellent policy statement, and stands as a tangible sign of Chairman Pitt's intention to forge a more cooperative, and less confrontational, relationship with corporate issuers. Nevertheless, it contains some significant ambiguities, and its true value to issuers and their counsel will lie not simply in its articulation, but in its implementation over the coming months and years.

The 21(a) Report arose in the context of the financial statements of Seaboard Corporation. Beginning in 1995 Gisela de Leon-Meredith, the Controller of a Seaboard subsidiary called Chestnut Hill Farms, booked entries in Chestnut Hill's accounts that overstated a deferred asset and understated certain expenses. According to the SEC, by December 1998 Meredith knew that these entries were improper, but instead of disclosing the problem to her superiors at Chestnut Hill or at Seaboard, she attempted to conceal the accounting errors through other adjustments. Late in 1999, Seaboard began inquiring about Meredith's entries, and in July 2000, after Seaboard's internal audit department questioned her about the matter, Meredith confessed. The internal auditors notified the audit committee of Seaboard's board; the full board authorized the retention of outside counsel to conduct an investigation; Meredith and two of her supervisors were dismissed; the company disclosed publicly and to the Commission that its financial statements would be restated, and thereafter a restatement was issued. The restatement covered the years 1995-1999, and reduced annual net earnings (which had fluctuated widely from year to year) by amounts that ranged from 2.7% to 80%; total assets at March 31, 2000, were reduced by .6%, and shareholders' equity by .9%. Seaboard's share price did not decline either after the company's initial announcement, or after the restatement became public.

Describing Seaboard's cooperation with the ensuing SEC Enforcement investigation, the 21(a) Report notes that the company “produced the details of its internal investigation, including notes and transcripts of interviews of Meredith and others; and it did not invoke the attorney-client privilege, work product protection or other privileges or protections with respect to any facts uncovered in the investigation.” Seaboard also voluntarily took

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a number of steps to strengthen its financial reporting processes, including its internal controls, in the wake of Meredith's conduct. Based on all of these considerations, the SEC determined not to charge the company with any wrongdoing. The only enforcement case to emerge from these events was a settled administrative proceeding against Meredith in which she was ordered to cease and desist from violations of the periodic reporting, books and records, and circumvention of accounting controls provisions (Exchange Act Rel. No. 44970, AAER No. 1471 (Oct. 23, 2001)).

To an observer who is not familiar with the SEC's recent accounting enforcement program, the result in *Seaboard* might seem unsurprising, since the wrongdoing was located in a different corporate entity geographically removed from the publicly-traded parent, was perpetrated by a single mid-level employee of the issuer, and was aggressively ferreted out and exposed by the parent. However, this is an uncommon outcome, and the SEC not only related it to Seaboard's cooperation, but also, as is typical in Section 21(a) reports, used Seaboard as a platform from which to speak much more broadly about cooperation. The Report lists 13 specific criteria, clustered under four rubrics – self-policing, self-reporting, remediation, and cooperation with law enforcement authorities – that the Commission has said it will consider in deciding whether to take what it describes as “the extraordinary step of taking no enforcement action,” or whether to agree to the somewhat more traditional palliatives of reduced charges, lighter sanctions, or the inclusion of mitigating language in the charging documents. The 13 criteria are:

1. What is the nature of the misconduct involved? Did it result from inadvertence, honest mistake, simple negligence, reckless or deliberate indifference to indicia of wrongful conduct, willful misconduct or unadorned venality? Were the company's auditors misled?
2. How did the misconduct arise? Is it the result of pressure placed on employees to achieve specific results, or a tone of lawlessness set by those in control of the company? What compliance procedures were in place to prevent the misconduct now uncovered? Why did those procedures fail to stop or inhibit the wrongful conduct?
3. Where in the organization did the misconduct occur? How high up in the chain of command was knowledge of, or participation in, the misconduct? Did senior personnel participate in, or turn in a blind eye toward, obvious indicia of misconduct? How systemic was the behavior? Is it symptomatic of the way the entity does business, or was it isolated?
4. How long did the misconduct last? Was it a one-quarter, or one-time, event, or did it last several years? In the case of a public company, did the misconduct occur before the company went public? Did it facilitate the company's ability to go public?

5. How much harm has the misconduct inflicted upon investors and other corporate constituencies? Did the share price of the company's stock drop significantly upon its discovery and disclosure?
6. How was the misconduct detected and who uncovered it?
7. How long after discovery of the misconduct did it take to implement an effective response?
8. What steps did the company take upon learning of the misconduct? Did the company immediately stop the misconduct? Are persons responsible for any misconduct still with the company? If so, are they still in the same positions? Did the company promptly, completely and effectively disclose the existence of the misconduct to the public, to regulators and to self-regulators? Did the company cooperate completely with appropriate regulatory and law enforcement bodies? Did the company identify what additional related misconduct is likely to have occurred? Did the company take steps to identify the extent of damage to investors and other corporate constituencies? Did the company appropriately recompense those adversely affected by the conduct?
9. What process did the company follow to resolve many of these issues and ferret out necessary information? Were the Audit Committee and the Board of Directors fully informed? If so, when?
10. Did the company commit to learn the truth, fully and expeditiously? Did it do a thorough review of the nature, extent, origins and consequences of the conduct and related behavior? Did management, the Board or committees consisting solely of outside directors oversee the review? Did company employees or outside persons perform the review? If outside persons, had they done other work for the company? Where the review was conducted by outside counsel, had management previously engaged such counsel? Were scope limitations placed on the review? If so, what were they?
11. Did the company promptly make available to our staff the results of its review and provide sufficient documentation reflecting its response to the situation? Did the company identify possible violative conduct and evidence with sufficient precision to facilitate prompt enforcement actions against those who violated the law? Did the company produce a thorough and probing written report detailing the findings of its review? Did the company voluntarily disclose information our staff did not directly request and otherwise might not have uncovered? Did the company ask its employees to cooperate with our staff and make all reasonable efforts to secure such cooperation?

12. What assurances are there that the conduct is unlikely to recur? Did the company adopt and ensure enforcement of new and more effective internal controls and procedures designed to prevent a recurrence of the misconduct? Did the company provide our staff with sufficient information for it to evaluate the company's measures to correct the situation and ensure that the conduct does not recur?
13. Is the company the same company in which the misconduct occurred, or has it changed through a merger or bankruptcy reorganization?

Application of the SEC's 13 cooperation criteria will often be a complex task. Most obviously, the Section 21(a) Report contains a number of caveats that, all by themselves, ensure a less than fully predictable system. "Facts and circumstances" are not dead, and the Commission has (1) reserved the right to trump all of its criteria with its assessment of what best protects investors in a given case, (2) said that its criteria do not limit its discretion and do not confer rights on anyone, and (3) stated that it may consider criteria other than the 13 specified in its Report. Moreover, some of the 13 criteria themselves present issues that are far from simple or straightforward. They include the following:

- Criterion 5, echoing SAB 99, measures the "harm to investors" from corporate misconduct by asking "Did the share price of the company's stock drop significantly upon its discovery and disclosure?" While everyone can agree that a flat share price after disclosure (as happened in the Seaboard situation) indicates lack of materiality and lack of harm to investors, a stock that *does* drop after a restatement may do so for a number of reasons, including other company news that is released at about the same time, extraneous factors affecting the sector in which the company competes, and the performance of the market as a whole. Moreover, temporary price declines should not be counted heavily against the company, as Congress indicated when it included a provision in the PSLRA limiting damages in situations where the mean stock price in the 90 days following disclosure recovers from its post-disclosure low.
- Criterion 6 – "How was the misconduct detected and who uncovered it?" – should not be applied mechanically, because the sequence of events that leads a company to uncover particular wrongdoing and cooperatively reveal it to the SEC may have originated in an SEC inquiry into related, but different, misconduct.
- The last of several questions in Criterion 8 is "Did the company appropriately recompense those adversely affected by the conduct?" "Recompense" in a financial reporting case is a thorny issue. If private shareholder lawsuits have been filed against the company, the SEC is not well positioned to evaluate the "appropriateness" of the company's resolution of those suits, and indeed that resolution may not even be known at the time when the enforcement decision is being considered. If no such lawsuits are filed, the company lacks a mechanism to evaluate or redress investor

losses apart from paying disgorgement in an SEC enforcement action, which is unlikely to be appropriate in most cases because the corporation has neither profited from, nor avoided losses in, market trades in its own securities.

- The possibility of collateral private litigation also greatly complicates compliance with Criterion 11, in which the SEC poses the questions “Did the company identify possible violative conduct and evidence with sufficient precision to facilitate prompt enforcement actions against those who violated the law?” and “Did the company produce a thorough and probing written report detailing the findings of its review?”

Footnote 3 to Criterion 11 invites issuers not to assert the attorney-client privilege or the work product protection against the SEC’s staff. The issue of whether to waive privileges requires extremely careful analysis by an issuer and its counsel. Convincing a court that the attorney-client privilege has *not* been waived as to materials produced to the SEC can best be described as an uphill sled. Even as to the more flexible work product doctrine, the SEC’s only reference for the proposition that production to the government under a confidentiality agreement does *not* result in waiver is the SEC’s amicus brief in a pending Georgia state case in which that very issue is under consideration.

Undercutting somewhat the SEC’s acknowledgment that the attorney-client privilege and the work product protection “serve important social interests,” the Commission has subjected them to a two-pronged assault, represented by the carrot of leniency-for-waiver offered by the Section 21(a) Report, and the stick of subpoena enforcement that the SEC has swung against certain parties under investigation in the *USA Detergents* matter (*see* Lit. Rel. No. 17101). In *USA Detergents*, the Commission is arguing that the privileges protecting a Special Committee report and the underlying materials were waived when corporate officers cited those materials in their Wells submissions.

The 21(a) Report’s reference to “identify[ing] possible violative conduct and evidence with sufficient precision to facilitate prompt enforcement actions,” and its apparent preference for a written report of the investigative findings, sound uncomfortably close to a request not only for the *facts* uncovered in a corporate investigation (which Seaboard, for example, is described as having produced), but also for counsel’s views on what those facts *mean* under the securities laws – the core opinion work product that is given special protection by the courts (*see* Federal Rule of Civil Procedure 26(b)(3)). It would seem far more reasonable for the SEC to focus on disclosure of facts, and to let its own well-trained staff determine what to make of them.

Although the issues discussed above will require careful attention, there is no question that the SEC has done a service to issuers, the investing public, and counsel by starting to demystify the topic of “cooperation.” In particular, despite its characterization of “no enforcement action” as an “extraordinary” result, the fact that the SEC has attached the Damoclean sword of enforcement to the ceiling by a few more hairs is a big step in the right direction. It remains to be seen, of course, how ready the SEC will be to forego enforcement in particular cases, and whether the Commission and staff will take the equally important step of extending their “self-policing, self-reporting, remediation, and cooperation” analysis to corporate directors, officers and employees who were not themselves involved in the misconduct. It will also be interesting to see whether the Commission will be willing to forego enforcement against *both* a cooperating issuer *and* its officers, directors, and employees when the consequence of such a course is that there is no public action by the SEC at all.

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Morgan Lewis’ Securities Practice has developed a team to help public companies and individual officers and directors focus on crisis management with respect to accounting, financial reporting, and related disclosure issues. The team can help resolve issues that may arise with the SEC’s Division of Corporation Finance and Office of the Chief Accountant, conduct internal investigations, and defend enforcement investigations and litigation. Morgan Lewis’ Securities Practice includes 36 lawyers with significant service at the U.S. Securities and Exchange Commission, and our attorneys have broad experience in representing clients in these types of matters. Through an integrated team approach and a network of offices throughout the country, our clients gain focused extensive experience as well as a broad geographic reach. The liaisons for this service team are:

Linda L. Griggs	Former Chief Counsel to the SEC Chief Accountant
Paul Huey-Burns	Former Assistant Director, SEC Division of Enforcement
Christian J. Mixter	Former Chief Litigation Counsel, SEC Division of Enforcement

Whom We Serve

Public companies in both new and old economy businesses face accounting and financial reporting issues such as:

- Revenue recognition
- The recognition of reserves
- The recognition of an impairment of the value of assets
- Restructuring charges
- The appropriate accounting for related party transactions
- The impact on accounting decisions of changes in management
- The adequacy of Management's Discussion and Analysis
- The need for financial statements of a purchased product or product line
- The adequacy of the internal controls and the books and records on which the financial reporting process relies
- The responsibilities of audit committees and boards of directors with respect to financial reporting
- The independence of the company's auditors and the potential impact of independence issues on the financial statements.

What We Do

Careful Responses to SEC Comments

In many instances, accounting matters begin when a company receives comments from the SEC's Division of Corporation Finance. Responses to the SEC staff's accounting comments must be prepared carefully, because an inadequate response can raise additional questions, result in the company's accounting issues being referred to the SEC's Enforcement Division, or fail to satisfy the SEC staff that the company's financial statements comply with generally accepted accounting principles. We act as our clients' advocates with the SEC's accounting staff.

The review that precedes preparation of the response to the Division of Corporation Finance can help management address questions regarding newly discovered facts; suggest the need for a meeting or teleconference with the SEC's accounting staff; or even identify the need for a restatement of the company's financial statements. We advise management, the Audit Committee and the Board about their responsibilities in these areas.

Special Investigations

If newly discovered facts raise concerns about a company's books and records or internal controls, the company may need to conduct a special investigation to discharge the directors' and officers' fiduciary responsibilities, and to satisfy its outside auditors that no illegal act has occurred. If the financial statements must be restated, it is critical that disclosures be carefully crafted to limit as much as possible the impact of the restatement on possible litigation. We have the experience and the capabilities to conduct special investigations, and to advise on disclosure issues.

Advocates at the Agency and in the Courts

Some accounting and financial reporting problems will lead to SEC enforcement and litigation. We represent companies before the SEC Enforcement Division and in private civil litigation, including class action suits. If, as is increasingly common, criminal prosecutors take an interest in the case, we can call upon the lawyers in Morgan Lewis' Corporate Investigations and Criminal Defense Practice to handle the criminal matter.

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