

**The New York Stock Exchange and Cooperation —  
Another Precinct Heard From**

**October 2005**

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Following in the footsteps of the Securities and Exchange Commission (“SEC”)<sup>1</sup> and the Department of Justice (“DOJ”),<sup>2</sup> on September 14, 2005, the New York Stock Exchange (“the NYSE” or “the Exchange”) issued *Information Memorandum No. 05-65*, in which the NYSE’s Division of Enforcement explains to the Exchange community its thinking on the meaning and virtues of corporate cooperation with regulators. The Information Memorandum is noteworthy because it attempts to fit the concept of “creditworthy” cooperation into the framework of a self-regulatory organization<sup>3</sup> by defining a new goal of “extraordinary cooperation,” and also highlights some of the dicier aspects of the “cooperative” regime under which corporate America has lived for the past four years.<sup>4</sup>

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<sup>1</sup> See *Statement on the Relationship of Cooperation to Agency Enforcement Decisions*, Securities Exchange Act Release No. 44969, 2001 LEXIS 2210 (Oct. 23, 2001) (commonly referred to as the “Seaboard Report”), which we discussed in our White Paper entitled *The SEC’s New Cooperation Guidelines – Progress, and Some Possible Pitfalls* (Nov. 2001).

<sup>2</sup> See *Principles of Federal Prosecution of Business Organizations*, Memorandum from Larry D. Thompson, Deputy Attorney General, to Heads of Department Components, United States Attorneys (Jan. 20, 2003) (commonly referred to as the “Thompson Memorandum”), which we discussed in our White Paper entitled *Department of Justice Revised Principles of Prosecution of Business Organizations Require Increased Corporate Vigilance* (Feb. 2003).

<sup>3</sup> On October 7, 2005 the NYSE issued *Information Memorandum No. 05-77* in which the Enforcement Division identifies cooperation as one of fourteen factors that it will consider in determining sanctions, but emphasizes that credit worthy cooperation must be “proactive and exceptional” and credit will not be given for simply doing what the Exchange Rules require. The NASD also briefly addresses the concept of cooperation in its Sanction Guidelines by suggesting that a potential mitigating factor to be considered in conjunction with the imposition of sanctions is whether a respondent provided “substantial assistance” to NASD Regulation in an examination or investigation. See NASD Sanction Guidelines, *Principal Considerations in Determining Sanctions*, No. 12.

<sup>4</sup> The Public Company Accounting Oversight Board (“PCAOB”) has also recently stressed the importance of cooperation within the context of its inspections and

## Cooperation in Context

In its *Seaboard* Report, the SEC took a prescriptive approach, telling public companies that they hold the keys to leniency, and that those keys are self-policing, self-reporting, remediation, and cooperation with law enforcement. The Thompson Memorandum, more descriptive in tone, described nine factors that DOJ uses in the exercise of prosecutorial discretion with respect to a public company and highlighted the two factors – timely and voluntary disclosure, and the corporation’s remedial actions – that represent real choices for a company after it discovers the existence of a problem.<sup>5</sup> Both documents share a common point of departure: they assume that unless public companies affirmatively wish to get credit for cooperation, their only obligation is to comply with the rules and norms of the adversary system (enforced by the false statements and obstruction of justice statutes), by responding truthfully when asked questions by the SEC Staff or by DOJ – in other words, to “turn square corners when they deal with the Government.”<sup>6</sup>

As a self-regulatory organization, the NYSE starts from a somewhat different place. Membership in a self-regulatory organization imposes affirmative duties upon a regulated person or entity, epitomized most recently by *In the Matter of Department of Enforcement v. Frank Peter Quattrone*,<sup>7</sup> that do not apply to the population as a whole. To a certain extent, those duties make self-policing, self-reporting, remediation, and cooperation mandatory. As examples of cooperation that, in its view, is required by virtue of Exchange membership, the NYSE’s Information Memorandum cites to rules

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enforcement processes. Speaking at a September 13, 2005 New York State Society of Certified Public Accountant’s Current Developments under the Sarbanes-Oxley Act Conference, PCAOB director of enforcement and investigations Claudius Modesti stated that its regulatory model is based on cooperation and suggested that, “lack of cooperation can make a bad situation far worse.”

<sup>5</sup> Seven of the nine Thompson factors (the nature and seriousness of the offense, the pervasiveness of the wrongdoing, the corporation’s legal and regulatory history, the adequacy of its compliance program, the collateral consequences of corporate prosecution upon innocent parties, the adequacy of prosecutions of individuals and the adequacy of civil or regulatory enforcement actions as alternatives to corporate criminal charges) lie outside the company’s control in responding to a current problem.

<sup>6</sup> *Rock Island, A. & L. R. Co. v. United States*, 254 U.S. 141, 143 (1920) (Holmes, J.).

<sup>7</sup> Complaint No. CAF030008 (NASD National Adjudicatory Council, Nov. 22, 2004) (barring investment banker from brokerage business for failing, on advice of counsel in view of parallel criminal investigation, to provide testimony in response to NASD request under Rule 8210), *petition for review by Securities and Exchange Commission pending*, No. 3-11786.

that mandate the timely disclosure of reportable matters (*see* Exchange Rules 345 and 351), prompt, accurate responses to inquiry and investigation requests (*see* Exchange Rules 476 and 477), and the Exchange’s ability (and a member organization’s inability) to dictate the order, direction, and scope of an investigation.<sup>8</sup>

Thus, to identify how a member organization might go beyond what is required and thereby cause the NYSE to consider a reduced sanction, lesser charges, or even no charges, the NYSE was compelled to invent the concept of “extraordinary cooperation.” According to the Information Memorandum, “extraordinary cooperation” involves adherence to the following eight standards:

1. **Prompt, Full Disclosure Coupled with Thorough Internal Review**

- Accurate and full disclosure of possible misconduct within the securities community is essential to self-regulation, and before a firm’s cooperation may be considered exceptional, its reporting must be more than adequate.
- Firms must provide the Exchange with prompt, detailed reporting of suspected or uncovered violations.
- Better situated are firms that follow early disclosure with vigorous and thorough internal reviews, that share the facts discovered with the Exchange, and that compensate customers and others that have been harmed.

2. **Candor with the Exchange**

- A firm seeking credit for exceptional cooperation must supply to the Exchange the full and unvarnished record concerning the misconduct at issue, including its causes and consequences.

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<sup>8</sup> In highlighting the affirmative obligations that go with membership in a self-regulatory organization, one must not, of course, overlook the fact that many regulated entities may also have such obligations to the SEC. For instance, registered entities such as broker-dealers and investment advisers must maintain accurate books and records and make them voluntarily available for inspection and production, and are subject to routine and surprise Commission examinations. Issuers of securities must file true and accurate prospectuses and financial materials. Chief executive officers and chief financial officers of these issuers and principals of regulated entities must certify the accuracy of these financial statements and other reports and will be held responsible for false and misleading statements in them. Broker-dealers and investment advisers are held to disclosure standards in their Forms BD and ADV. Corporate counsel also are not immune from affirmative disclosure duties, although those duties are focused on reporting evidence of material violations of securities laws or fiduciary duties up the corporate ladder rather than to regulators.

- In evaluating candor, the Exchange will consider whether a firm has been fully forthcoming with information that may affect the course and conduct of Exchange investigations.

### 3. **Waiver of Attorney-Client Privilege**

- The Exchange will consider the waiver of the attorney-client privilege or any other relevant privilege as a significant step in demonstrating a level of commitment to the NYSE's investigation sufficient to advance a claim of exceptional cooperation.
- Likewise, supplying employee interview notes and reports of firm investigations can be a potent means of demonstrating commitment to cooperation.
- The essence of cooperation is that facts relevant to an investigation must be made available to Exchange investigators, and as long as those facts are candidly and completely presented, there will be no adverse effect arising from the non-waiver of a privilege. Yet, a firm must find ways to convey relevant facts without compromising the privilege sought to be maintained.

### 4. **Breadth, Depth and Timeliness of Remedial Action**

- A firm's response to a discovered violation is vital in assessing its commitment to investor protection and market integrity. Evaluation of a firm's response includes the consideration of, among other things:
  - Whether the firm sought to address problems promptly;
  - Whether, when, and what augmented procedures were put in place to prevent the recurrence of the misconduct;
  - How thoroughly the firm investigated the matter;
  - Whether the firm sought to uncover similar misconduct by others;
  - Whether the firm promptly evaluated whether supervision was adequate; and
  - Whether the firm timely reimbursed customers for losses.

### 5. **Responses to Investigative Requests**

- A firm or individual cannot claim credit for extraordinary cooperation while consistently missing Exchange investigative deadlines, providing incomplete or misleading responses to information of document requests, or otherwise delaying or impeding the progress or resolution of an investigation.

### 6. **Aiding the Jurisdiction of the Exchange**

- It is notable when an individual or firm provides substantial assistance to an investigation by obtaining and providing evidence and/or testimony from persons beyond the jurisdictional reach of the Exchange.

## 7. **Culture of Compliance**

- The presence of a strong culture of compliance may appropriately influence the Exchange's discipline-related decision.
- A culture of compliance is usually demonstrated by a sparse disciplinary history, thorough self-policing, informative and complete self-reporting, prompt customer remediation, and consistent cooperation with the Exchange and other regulatory bodies.

## 8. **Partnering with the Exchange to Uncover Wrongdoing**

- When ongoing violative conduct has numerous participants, yet is longstanding and perhaps difficult to uncover, self-reporting to and collaboration with the Exchange can have a dramatic impact on regulatory consequences.
- Where an individual or firm brings to the Exchange's attention a pattern or practice that the NYSE has been unaware of, or is the first to come forward to cooperate in an investigation that is already underway, that individual or firm will, subject to various limitations and caveats, receive special consideration, including, where appropriate, no Exchange enforcement action.

For a member organization (or individual) that successfully convinces the Exchange that its cooperation warrants extraordinary cooperation credit, favorable treatment may include:

- A reduced number of charges;
- A reduced sanction;
- Obviating the need for an undertaking or impacting the type of undertaking required;
- Adding language to the documents that resolve enforcement proceedings to mitigate the severity of the charges and/or credit the level of cooperation;
- Publicly acknowledging the level of cooperation in a press release; and
- In the "exceptional" case (of "exceptional" cooperation), no enforcement action.

## **Common Themes, Common Pitfalls**

The NYSE's description of "extraordinary" cooperation contains many elements that overlap with those previously set forth by the SEC and DOJ. In retracing this familiar ground, the NYSE reveals a number of the same dilemmas that firms have encountered under the SEC's and DOJ's cooperation programs.

*The Cooperation Factors are Fluid and Cooperation "Points" are Discretionary*

Although the SEC, DOJ, and now the NYSE have made major contributions by articulating benchmarks for cooperation, none of their cooperation regimes is fully predictable. "Points" for cooperation are not guaranteed because each agency makes the application of its cooperation criteria wholly dependent on the facts and circumstances of

the particular case. For example, the SEC reserved the right to trump its criteria with its assessment of what best protects investors in a given case, and stated “in the end, no set of criteria can, or should be strictly applied to every situation to which they may be applicable.” The Thompson Memorandum stated that the “prosecutor should weigh all of the factors considered in the sound exercise of prosecutorial judgment” and further stated that “the foregoing factors are intended to provide guidance rather than mandate a particular result.” The NYSE takes a similar tack, noting that its cooperation factors will not always determine whether enforcement action will be taken, and acknowledging the existence of other matters to be considered such as the nature of the violation, the extent of customer harm, the duration of the misconduct, and the existence of prior related discipline.

Therefore, it is important to recognize that NYSE enforcement determinations are fluid and are not susceptible to generalizations. In practice, this means that there is no guarantee that the member organization and the Exchange will agree on what behavior constitutes extraordinary cooperation, or what conclusions to draw from cooperation that is concededly extraordinary. In assessing whether extraordinary cooperation will lead to appropriately reduced sanctions or simply result in increased exposure to private litigation, a member firm and its counsel will be left to exercise judgment.

#### *Prompt Disclosures and Responses to Regulatory Inquiries*

The NYSE’s Information Memorandum does little to resolve, and in some ways exacerbates, the conundrum of when to approach the regulators with a problem. In its past guidance, the SEC has made clear that it will make a searching inquiry into a firm’s response to an investigation, including whether the company was committed to learning the truth fully and expeditiously and provided sufficient documentation reflecting its response to the particular situation. Likewise, DOJ included a corporation’s timely disclosure of wrongdoing and willingness to cooperate in an investigation as critical factors in evaluating charging decisions. The NYSE’s Information Memorandum also places great emphasis on the importance of a proactive response to an inquiry or investigation, observing that “a member firm cannot claim credit for extraordinary cooperation where it has failed to promptly investigate and address problems or where it has provided untimely, incomplete, or misleading responses to investigation requests.”

It is worth spending a moment to consider the internal contradictions in the NYSE’s formulation. Speed, completeness, and accuracy are seldom consistent. Premature self-reporting, or a too-hasty response to an NYSE investigative inquiry in an effort to be fully compliant and transparent, can result in crucial mistakes, including the provision of an incomplete and thereby inaccurate description of the facts that, however inadvertent, may later be cited as a lack of candor. In its Information Memorandum, the NYSE is quick to point out that member organizations put themselves at great risk when they portray themselves as having undertaken exceptional cooperation, only to be discovered as having withheld important facts or information. In the long run, the NYSE’s statement is incontestable. But at the beginning of an investigation – when it is unlikely that the member organization or outside counsel will have the complete and

accurate facts – it is a trap for the unwary. While it is crucial to quickly assemble the facts, disclose them, and appear open and cooperative with the Exchange, the member firm and outside counsel must take the time necessary to master those facts and determine what they mean. At the same time, the NYSE staff must understand these competing interests and recognize the difference between reporting an issue and reporting the results of a completed investigation.

*Waivers: Attorney-Client Privilege and Work-Production Protection*

The NYSE opens its discussion of privilege waivers by genuflecting to the concept of the privilege: “As a general principle, we at the Exchange afford great respect to the attorney-client privilege and value the social good it furthers.” However, the Exchange then loses little time in adding that “waiver of the attorney-client privilege or any other relevant privilege may demonstrate a level of commitment to the Exchange’s investigation and be sufficient to advance a claim of exceptional cooperation.” Thus, the NYSE memorandum arrives at much the same point as the *Seaboard* Report and the Thompson Memorandum before it<sup>9</sup> – the attorney-client privilege and work-product protection may be venerated as icons, but at the end of the day both are currency in the market for cooperation “points.”

This approach raises serious issues for member organizations on a number of fronts. To begin with the practical, a member organization under regulatory investigation often also faces parallel private litigation. Where that organization chooses to waive privilege to the NYSE, it may well be precluded from asserting privilege over the same materials in private litigation,<sup>10</sup> and the courts’ increasing tolerance for document

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<sup>9</sup> The SEC and the Exchange, in their guidance, have similarly recognized that the attorney-client privilege and work-product protection serve important social interests. Nonetheless, both also hold out the “carrot of leniency” for voluntary waivers of these longstanding protections. To be fair, DOJ has indicated that this waiver should ordinarily be limited to the factual internal investigation and any contemporaneous advice given to the corporation concerning the conduct at issue. DOJ, in most cases, will not seek a waiver of the attorney-client privilege with respect to legal advice concerning the government’s criminal investigation.

<sup>10</sup> See, e.g., *In re Columbia/HCA Healthcare Corp. Billing Practices Litig.*, 293 F.3d 289, 303 (6th Cir. 2002) (concluding that even where corporation provided privileged information to a regulator pursuant to a confidentiality agreement, corporation waived the attorney-client privilege as to all communications on the subject matter; likewise finding waiver of work-product protection); *Westinghouse v. Republic of the Phillipines*, 951 F.2d 1414 (3d Cir. 1991) (despite government’s agreement to maintain the confidentiality of the information, Westinghouse’s disclosure of documents from an internal investigation to the SEC and Department of Justice waived the attorney-client privilege or work-product protection for those materials); *United States v. Bergonzi*, 216 F.R.D. 487 (N.D. Cal. 2003) (company’s preparation of internal report and interview memoranda in contemplation of production to government, and its subsequent production of those materials to the government,

requests from civil plaintiffs that seek “all documents produced to the regulators” make it almost certain that the consequences of any such waiver will become acute at an early stage in the civil case. Moreover, waiver with respect to the particular materials shared with the regulators may only be the beginning of a defendant’s problems if the plaintiff advances a “subject matter waiver” argument.

Second, the Information Memorandum does nothing to resolve the problem, already highlighted by the SEC and DOJ cooperation regimes, that waiver of privileges can become, in the eyes of individual staff members handling an investigation, the norm rather than the exception, and that companies under investigation may be sufficiently desperate for “cooperation points” that they see no choice but to accede.<sup>11</sup> The Information Memorandum does note that so long as the facts relevant to an investigation are candidly and completely presented to the investigating staff, “there will be no *adverse* effect arising from the non-waiver of the privilege” (emphasis added). However, this formulation somewhat misses the point, because much of the pressure to waive privilege derives from the investigating staff’s unfettered ability to tell a firm that it can help itself if only it will “jump higher.” The NYSE missed an opportunity – which it could yet recapture in further guidance to its staff – to deal with the commoditization of the privilege by at least mandating that high-level supervisors in the Division of Enforcement be involved in any decision to “suggest” to a company under investigation that it waive privilege, much as DOJ requires supervisory approval before an Assistant United States Attorney can subpoena a journalist for information in aid of a criminal investigation.<sup>12</sup>

The Information Memorandum does contain a practical statement that bears emphasis. In a footnote, the Exchange states, “Because facts themselves are generally not protected and cannot be hidden behind a shroud of privilege, to fully cooperate, yet maintain the privilege, firms and counsel must find ways to convey relevant facts without compromising the privilege sought to be maintained.” In this statement, the NYSE captures one of the core realities in counseling member organizations under investigation, where the right answer normally is not the wholesale production of privileged materials, but the requirements of candor do not permit the selective disclosure of important facts. The Exchange’s explicit challenge to the ingenuity of defense counsel is, at the same time, an implicit challenge to its own staff to understand the sometimes-hard choices firms and their counsel must make.

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constituted waiver of all claims of privilege as to those materials notwithstanding confidentiality agreement between company and government).

<sup>11</sup> For a thoughtful treatment of this problem, see *Report of the American Bar Association’s Task Force on the Attorney-Client Privilege*, 60 Bus. Law. 1029 (May 2005).

<sup>12</sup> United States Attorneys’ Manual 9-13.400; *see also* 28 C.F.R. § 50.10.

## **Securities Investigation and Litigation**

### **Crisis Management Strategy**

Morgan Lewis is ideally positioned to help clients respond effectively to multifaceted, complex issues that arise in the wake of a full-blown corporate crisis. We have assembled a team of lawyers with the experience and skill to step in and successfully manage that corporate crisis for issuers or financial institutions.

Our securities investigation and litigation crisis management team partners with clients to develop a first response: immediately assessing potential exposure and its corresponding disclosure obligations, identifying the particular sensitivities of the situation and developing a comprehensive strategy to address the often inevitable follow-on investigations by federal and state securities regulators, DOJ and other governmental agencies, and the likely onslaught of potentially devastating class action litigation and “bet the company” derivative actions by company shareholders against the company’s board of directors. We recognize and understand the sensitivities in each situation and our lawyers are adept at working with management while minimizing disruption to company operations. We also have extensive experience in media/public relations, and will work with management to develop and implement a media crisis plan in conjunction with the development of our legal strategy.

With stakes so high, companies need counsel that have the experience to manage the immediate crisis and the substantive expertise to anticipate and address the myriad investigations and litigations that frequently ensue. Our securities investigation and litigation crisis management team includes many of the nation’s leading white collar, securities enforcement and securities litigation practitioners, who enjoy distinguished records of success in three main substantive areas that must be effectively and simultaneously managed in order to maximize a corporation’s protections and minimize its criminal, regulatory and civil exposure:

- **corporate investigations and white-collar defense**
- **securities enforcement defense**
- **securities litigation: class action and derivative action defense**

Morgan Lewis has a proven record of success in helping public issuers and financial institutions successfully negotiate the legal dangers and pitfalls confronting a corporation in crisis on all three of these fronts. Morgan Lewis is unique, however, in its ability to not only meet all of these needs but to also help our clients address related, but often under-appreciated, insurance issues. Our securities investigation and litigation crisis management team will also coordinate its efforts with the firm’s Global Insurance Recovery practice to identify and maximize sources of insurance coverage. During the

last decade the insurance recovery lawyers at Morgan Lewis have recovered close to \$12 billion in financial benefits for clients.

If you have any questions or require more information, please contact the following authors of this White Paper:

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