

The Complete Compliance and Ethics Manual 2023 Independent Investigations Overseen by the Audit Committee: Procedures and Guidance

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Introduction

Since the 2008 financial crisis, the discovery of the massive Bernie Madoff Ponzi scheme, and the enactment of the sweeping Dodd-Frank financial regulatory reform legislation, the Department of Justice (DOJ), the Securities and Exchange Commission (SEC), the Financial Industry Regulatory Authority (FINRA), and state attorneys general and regulators have increased their oversight and enforcement of white-collar criminal and securities laws. The SEC, for example, brought 697 enforcement actions in fiscal year (FY) 2021 and obtained approximately \$3.852 billion in penalties and disgorgement.^[2] In addition to regulators, the plaintiffs' securities bar, often assisted by whistleblowers, has been eager to bring cases against banks, financial services companies, and large corporations.

In this environment of increased scrutiny from both regulators and shareholders, corporate management and directors are under greater pressure to react quickly and decisively at the first indication of malfeasance or fraud. Failure to be proactive in the face of allegations of corporate misconduct can be financially devastating to a company and may expose management and directors—even independent directors—to personal liability.

Assessing the Situation

When faced with such allegations, the best defense is a mastery of the facts, which can be gleaned only from a full investigation of the problem. What happened? Who was involved? Was management at fault, either directing the misconduct or willfully turning a blind eye to it? Are policies, procedures, and controls in place to keep this from happening again?

To answer these questions and many others, a company typically has two choices:

1. To conduct an internal investigation overseen by management and led by in-house or outside corporate counsel; or
2. To conduct an independent, internal investigation overseen by the audit committee or special committee of the board of directors, using outside counsel that has not previously represented the company

Although an investigation overseen by management may be appropriate in certain situations, an independent investigation is the preferred, and often required, course to investigate suspected misconduct by management or potential violations of federal criminal or securities laws that could subject the company to a regulatory enforcement action.

Regulatory Standards

With scarce resources and increasing demands placed on them, government agencies such as the DOJ and SEC may show leniency for companies that conduct independent investigations overseen by an audit committee or a

special committee of the board. Frequently, one of the first questions a DOJ or SEC Division of Enforcement lawyer will pose to a company under investigation for serious misconduct is, “Does the company plan to conduct an independent investigation?” For government agencies, an independent investigation is viewed as more trustworthy than an investigation overseen by management. The independent directors on an audit committee or special committee—those overseeing an independent investigation—have fiduciary obligations to the shareholders to identify and remediate violations of laws, even if those violations occurred at senior management levels in the company. Moreover, to be considered independent, the investigation by the audit committee or special committee must retain counsel that has not worked previously at the direction of the management of the company. In other words, the counsel conducting the independent investigation must have no perceived bias toward management that might be viewed as influencing the investigation.

Other Considerations

An investigation, whether internal or independent, can be costly, time-consuming, and distracting in the near term. Any conduct warranting an independent investigation requires a thorough review, and the ultimate cost is tied to the nature and pervasiveness of the misconduct and the requisite scope of the independent investigation. Beyond the fees for legal and other expert services, investigations are distracting and can be uncomfortable for management, depending on the conduct being investigated.

Benefits of Independent Investigations

Where an independent investigation is warranted, however, such an investigation yields significant and tangible benefits that outweigh its costs and that are simply not available if the company proceeds with an in-house investigation. These benefits are described below.

Credibility and Options

An independent investigation gives the company credibility and options. First, an independent investigation best positions the company to demonstrate to regulators or law enforcement that the company has acted quickly and appropriately when confronted with misconduct. A competent and rigorous investigation conducted without the influence of management gives the company credibility and persuasive currency with its regulators. The SEC and the DOJ place a premium on robust and independent internal investigations overseen by audit committees, and they may reward such action through reduced sanctions or, in some notable cases, by not charging the company despite clear violations of the law. Second, an independent investigation gives the company the options and flexibility to address any significant problems (e.g., determine the extent of the suspected misconduct, remove culpable or incompetent employees from the company, and improve internal controls and policies to ensure that the identified misconduct cannot be repeated).

Leniency from the SEC

The SEC’s Seaboard Report, which is the SEC’s policy statement outlining some of the criteria the SEC considers in determining how much to credit a company’s cooperation, provides that the SEC may exercise leniency where an audit committee or special committee of the board has conducted an independent internal investigation. In evaluating whether to be lenient in terms of charges and sanctions, the Seaboard Report specifically asks: “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?”^[3] If the answer to most of these questions is yes, the company may be in line to receive cooperation credit from the SEC, which may temper or forestall an SEC-led investigation and positively influence charging

decisions. For example, the SEC investigated possible securities law violations by Salix Pharmaceuticals and its senior executives relating to statements by Salix of inventory amounts in its distribution channel. After conducting an internal investigation, Salix and the SEC reached a settlement in 2018 that did not involve a financial penalty for the company. In a statement announcing the settlement, the company stated, “After self-reporting to the SEC, Salix, and subsequently Valeant, conducted a thorough, independent investigation, fully cooperated with the SEC, and took strong remedial actions.” In a press release, the SEC credited the cooperation of Salix, stating that, “The settlement with Salix reflects the company’s self-report to the Commission and its significant cooperation with the investigation,” and “Salix’s proactive remediation included conducting an extensive internal investigation.”^[4]

Reduced Criminal Sanctions

Likewise, the Federal Sentencing Guidelines provide for reduced criminal sanctions for comparable forms of cooperation. Chapter 8 of the guidelines provides for reduced sanctions where a company “reported the offense to appropriate governmental authorities, fully cooperated in the investigation, and clearly demonstrated recognition and affirmative acceptance of responsibility for its criminal conduct.”^[5] The benefit of cooperating with the DOJ was on display in Walmart’s June 2019 settlement relating to the Foreign Corrupt Practices Act. Walmart entered into a three-year non-prosecution agreement, and criminal penalties paid by Walmart and its Brazilian subsidiary totaled \$138 million. According to the DOJ, the penalty reflected a 20% to 25% reduction off of the applicable sentencing guidelines. The DOJ credited the company’s cooperation and its disclosure of certain conduct abroad, specifically referencing that Walmart’s cooperation included, among other things, “conducting a thorough internal investigation; proactively identifying issues and facts that would likely be of interest to the [DOJ], and providing updates to the [DOJ]; making regular factual presentations to the [DOJ] ... [and] voluntarily making foreign-based employees available for interviews in the United States.”^[6]

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