

# The Complete Compliance and Ethics Manual 2024 Procedures and Guidance for Independent Investigations Overseen by the Audit Committee

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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. For example in 2022, the DOJ's Fraud Section obtained convictions of over 250 individuals and entered into seven criminal resolutions with corporations.<sup>[2]</sup> For its part, the SEC brought 760 enforcement actions in fiscal year (FY) 2022 and obtained approximately \$6.4 billion in penalties and disgorgement, which represents a 9% increase in enforcement actions over FY 2021 and an all-time record amount of penalties in a fiscal year.<sup>[3]</sup> In addition to criminal and regulatory authorities, the plaintiffs' securities bar, often assisted by whistleblowers and short sellers, has been eager to bring cases against banks, financial services companies, and large corporations.

In this environment of increased scrutiny, 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 a company is faced with allegations of corporate misconduct, the best defense is a mastery of the facts, which can be obtained only from a full investigation of the suspected misconduct. What happened? Who was involved? Was management at fault, either by directing the conduct or willfully turning a blind eye to it? Were policies, procedures, and controls in place to prevent the conduct? Are there new policies, procedures, and controls in place to prevent the conduct from happening again?

To answer these questions and others that may arise, 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 laws that could subject the company to a criminal or 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 toward 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 enforcement lawyer will ask whether the company plans to conduct an independent investigation. Government agencies consider independent investigations to be more trustworthy than investigations overseen by management because independent directors on an audit committee or special committee—*i.e.*, 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, truly independent investigations are conducted by outside counsel that has not previously worked at the direction of the company's management. The lack of a preexisting relationship with management mitigates potential concerns that the counsel conducting the investigation will be bias toward management or subject to management's influence in conducting the investigation.

## Benefits of Independent Investigations

Where an independent investigation is warranted, it can yield significant and tangible benefits that outweigh its costs and that are 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 independent investigation also 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, such as determining the extent of the suspected misconduct, removing culpable or incompetent employees from the company, and improving 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 investigation. In evaluating whether to be lenient in terms of charges and sanctions, the Seaboard Report specifically considers whether the company's review was conducted by management or independent persons from outside the company: "Did management, the Board or committees consisting solely of outside directors oversee the review? Did company employees or outside persons perform the review?"<sup>[4]</sup> If the company has conducted an independent investigation of the alleged misconduct, the company may receive cooperation credit from the SEC, which may temper or forestall an SEC-led investigation and positively influence the SEC's charging decisions. In a noteworthy case, 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 require the company to pay a

financial penalty. 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, “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.”<sup>[5]</sup>

## Reduced Criminal Sanctions

Likewise, the Federal Sentencing Guidelines provide for reduced criminal sanctions for companies that cooperate with DOJ investigations. 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.”<sup>[6]</sup> In the past two years, the DOJ has increased its focus on evaluating corporations’ cooperation with investigations. To be eligible to receive full cooperation credit under the Criminal Division’s Corporate Enforcement and Voluntary Self-Disclosure Policy, a company must make, among other things, “[t]imely disclosure of all non-privileged facts relevant to the wrongdoing at issue, including . . . facts gathered during a company’s independent internal investigation, if the company chooses to conduct one.”<sup>[7]</sup>

Several cases demonstrate the significant benefits of conducting an independent investigation.

- In December 2022, the DOJ entered into a deferred prosecution agreement with ABB Ltd., a Swiss-based global technology company listed on the New York Stock Exchange with core businesses focused on electrification, automation, motion, and robotics. According to the DOJ, ABB violated the FCPA by bribing a high-ranking official at South Africa’s state-owned energy company in order to obtain confidential information and win lucrative contracts. ABB hired outside counsel to conduct an internal investigation. The DOJ determined that deferred prosecution and a 25% criminal penalty reduction were appropriate after evaluating several factors, including ABB’s efforts to assist with the investigation, ABB’s “root-cause analysis of the misconduct,” and “ABB’s extraordinary cooperation with the [DOJ’s] investigation.”<sup>[8]</sup> Notably, neither the DOJ nor the SEC imposed a third-party compliance monitor.<sup>[9]</sup>
- In September 2020, the DOJ entered into a non-prosecution agreement with Power Solutions International, Inc. relating to allegedly fraudulent inflation of the company’s revenue. The audit committee of the company’s board hired outside counsel to conduct an independent investigation of the DOJ’s allegations. The DOJ gave the company full credit for its cooperation and decided it would not prosecute the company, in exchange for, among other things, its continued cooperation in the criminal prosecution of some of the company’s former employees.<sup>[10]</sup>
- In 2019, the DOJ entered into a deferred prosecution agreement with Celadon Group, Inc. relating to alleged securities and accounting fraud. Although the company did not receive voluntary disclosure credit, the company still obtained a deferred prosecution agreement due, in part, to its retention of “an external law firm to conduct an independent investigation.”<sup>[11]</sup>

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