

Session: 93

**SOX Heightens SEC's
Watchful Eye in Corporate
Fraud Investigations**

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10/11/2005

10:00 a.m. - 11:00 a.m.

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**SOX Heightens SEC's Watchful Eye in
Corporate Fraud Investigations**

Authority for enforcing U.S. accounting principles rests with the Securities and Exchange Commission (SEC). In this session, panelists offer insight into the issues and requirements regarding SEC fraud investigations in this era of increased scrutiny following passage of the Sarbanes-Oxley Act.

Learning Objectives

- Grasp the steps to be taken before and during an investigation
- Understand the Audit Committee's needs
- Detect fraudulent activity and investigate any wrongdoing
- Understand how to preserve documents and protect yourself

Pre-requisites

- General knowledge of Sarbanes-Oxley

Take Aways

- Reprint of article from “Securities Regulation Law Journal”
- Synopsis of recent cases

The AFP[®] Annual Conference

SOX Heightens SEC's Watchful Eye in Corporate Fraud Investigations

October 11, 2005

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The Commission considers it essential for board members to move aggressively to fulfill their responsibilities to oversee the conduct and performance of management and to ensure that the company's public statements are candid and complete. The Commission has long viewed the issue of corporate governance and the fiduciary obligations of members of management and the boards of directors of public companies to their investors as an issue of paramount importance to the integrity and soundness of our capital markets. . . . These obligations are particularly acute where potential violations of the federal securities laws involving self-dealing and fraud by management are called to the attention of the board of directors. In this case, [the] Board failed to satisfy its obligations when confronted by serious indications of management fraud.

Report of Investigation in the Matter of the Cooper Companies, Inc.

Agenda

Corporate Investigations After Sarbanes-Oxley

How To Prepare Your Company For When The SEC Comes

Navigating Technology Issues During Investigations

Whistleblowers

- (4) COMPLAINTS.--Each audit committee shall establish procedures for--
- (A) the receipt, retention, and treatment of ***complaints received by the issuer regarding accounting, internal accounting controls, or auditing matters***; and
 - (B) the confidential, anonymous submission by employees of the issuer of ***concerns regarding questionable accounting or auditing matters***.

Pub. L. 107-204, Section 301.

Authority to Investigate

(5) AUTHORITY TO ENGAGE ADVISERS

Each audit committee shall have the authority to engage independent counsel and other advisers, as it determines necessary to carry out its duties.

Pub. L. 107-204, Section 301.

When Directors May Consider Investigations

- When directors learn of potential self-dealing or fraud, whether through government action, the press, or employee inquiries
- When a shareholder makes demand on the board to act concerning a potential claim of the corporation
- When there is a concern about an accounting, internal accounting control, or audit matter

The Advantages

- Providing a diligent and impartial determination
- Offering a less costly investigation that may convince governmental entities not to pursue a more costly and distracting investigation
- Providing a factual basis for claims against the wrongdoer
- Providing directors with the information they need

The Disadvantages

- Affecting company morale in a negative way
- Absorbing substantial expenses related to the investigation
- Discovering negative information that could lead to shareholder litigation

Who Should Do The Investigation?

- Management?
- In-House Counsel?
- Auditors?
- Outside Counsel?

Independence – S-O Sec. 301

- Audit Committee members must be “independent”
- “Independent” not clearly defined in S-O: not “affiliated person”
- Under SLC precedents, it depends on the circumstances
 - Defendant or potential liable party?
 - Participation in or approval of the alleged wrongdoing?
 - Business dealings for the corporation ?
 - Business or social dealings with the individual defendants?
 - Number of members and/or structural bias?
 - Independent counsel and consultants?

A Key Detail: Scope

- Areas or issues that are not reviewed may well impact the outcome of the investigation and render it ineffectual
- An investigation that does not provide an accurate assessment may prove more costly than any costs saved by limiting the investigation

What Is a Thorough Investigation?

- Interviews
- Documents and/or financial transactions at issue
- Legal authority applicable to plaintiff's claims
- Report
- Exercise caution regarding excessive contact, involvement of in-house counsel

Maintenance of Privilege

- A thorough investigation requires consideration of many alternatives
- Will the information collection process damage ultimate conclusions?
- Creation, management, maintenance, and dissemination of information
- The relationship between the Committee and the corporation – who is the client?

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Recent 404 Guidance From SEC

- Auditors have gone too far a field in their interpretation of 404
- A “risk-based approach” should be adopted instead of the flawed “mechanistic, check-the-box exercise. This was not the goal of the Section 404 rules.”
- The SEC specifically noted that fraud was a major area of risk that a proper control structure will be able to prevent, deter and detect.

Recent 404 Guidance From SEC

- The SEC defines “general IT controls” to include “controls over program development, program changes, computer operations, and access to programs and data.”
- “For purposes of the Section 404 assessment, the staff would not expect testing of general IT controls that do not pertain to financial reporting.”
- Enterprise Computer Forensics: Not an IT Process per se But a Critical Tool to Detect and Investigate Fraud – a Critical Risk.

Document Destruction Prohibition

- Post Arthur Anderson

- US Supreme Court Vacated Arthur Anderson's Conviction For Obstruction of Justice For Destruction of Documents
- Case Involved Pre-SOX Obstruction Statute
- Section 802 of Sarbanes-Oxley:
 - More Specific Requirements vis-à-vis Document
 - Involves Government inquiries in addition to a multitude of proceedings, including bankruptcy
 - Addresses "Contemplated" as well as Pending Proceedings



U.S. Department of Justice

Office of the Deputy Attorney General

The Deputy Attorney General

Washington, D.C. 20530

January 20, 2003

MEMORANDUM

TO: Heads of Department Components
United States Attorneys

FROM: Larry D. Thompson
Deputy Attorney General

SUBJECT: Principles of Federal Prosecution of Business Organizations

The critical factors in evaluating any program are whether the program is adequately designed for maximum effectiveness in preventing and detecting wrongdoing by employees and **whether corporate management is enforcing the program**. Prosecutors should also consider the promptness of any disclosure of wrongdoing to the government and **the corporation's cooperation in the government's investigation....** Prosecutors should therefore attempt to determine whether a corporation's compliance program **is merely a "paper program."**

A. General Principle: Corporations should not be treated leniently because of their artificial nature nor should they be subject to harsher treatment. Vigorous enforcement of the criminal laws against corporate wrongdoers, where appropriate results in great benefits for law enforcement and the public, particularly in the area of white collar crime. Indicting corporations for wrongdoing enables the government to address and be a force for positive change of corporate culture, alter corporate behavior, and prevent, discover, and punish white collar crime.

B. Comment: In all cases involving corporate wrongdoing, prosecutors should consider the factors discussed herein. First and foremost, prosecutors should be aware of the important public benefits that may flow from indicting a corporation in appropriate cases. For instance, corporations are likely to take immediate remedial steps when one is indicted for criminal conduct that is pervasive throughout a particular industry, and thus an indictment often provides a unique opportunity for deterrence on a massive scale. In addition, a corporate indictment may result in specific deterrence by changing the culture of the indicted corporation and the behavior of its employees. Finally, certain crimes that carry with them a substantial risk of great public harm, e.g., environmental crimes or financial frauds, are by their nature most likely to be committed by businesses, and there may, therefore, be a substantial federal interest in indicting the corporation.



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Thursday, February 3, 2005

Sarbanes-Oxley Forces Attorneys to Confront E-evidence Issues

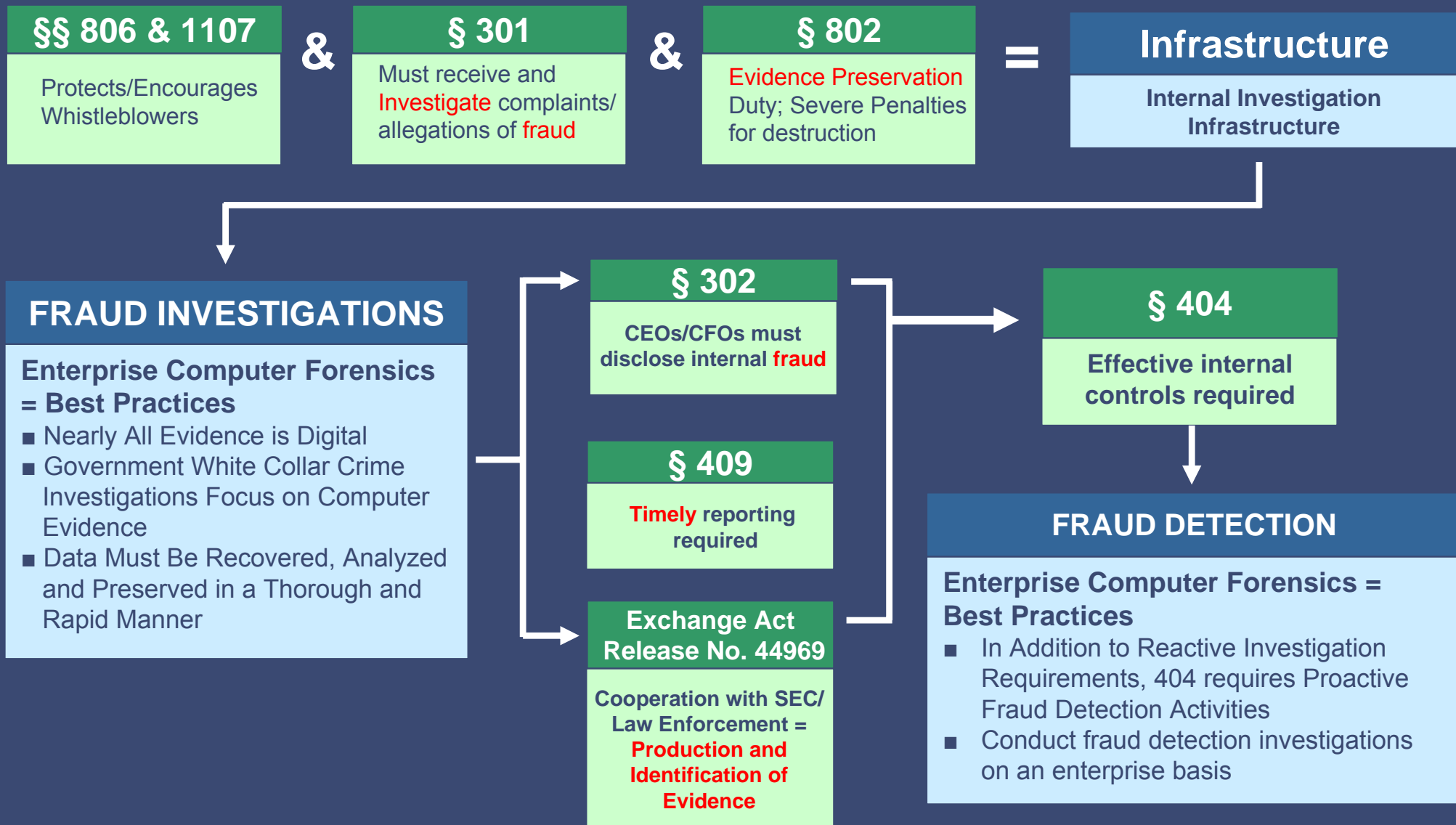
Investigating whistleblower complaints under the 2002 Sarbanes-Oxley Act requires corporate attorneys to become part detective and part crime scene investigator because of the unique reporting requirements under the law and the unusual nature of corporate responsibility cases, a panel of lawyers said Jan. 20 at a seminar sponsored by the Practising Law Institute.

"I sometimes feel being a lawyer now means being more like Columbo or being on *CSI*," said panelist Theodore O. Rogers Jr., of Sullivan & Cromwell, New York. The nature of Sarbanes-Oxley investigations requires both in-house and outside counsel to act as more than just advocates, and to also manage how claims are going to be investigated and control the flow of attorneys representing the various people and interests involved in an allegation of corporate mismanagement.

The sleuthing needed by attorneys relates to the large variety of documents that need to be reviewed, including e-mail, and conducting interviews of key employees. All of this work, Rogers argued, needs to be done with an eye toward not raising serious questions within the organization or to outside regulators.

Read the February issue of [Digital Discovery & e-Evidence](#) for the PLI panel's advice on conducting Sarbanes-Oxley investigations.

A Closer Analysis of SOX



SEC Rule on Cooperation

- SEC views effective self-policing and cooperation with law enforcement as mitigating or eliminating corporate liability
- SEC looks at 4 measures (SEC Release 2001-117):
 - Self-policing prior to the discovery of the misconduct
 - Self-reporting of misconduct when it is discovered, including conducting a thorough review of the nature, extent, origins and consequences of the misconduct
 - Remediation ... modifying & improving internal controls
 - Cooperation with law enforcement, providing SEC with all information relevant to the underlying violations

SEC Rule on Cooperation

- In order to cooperate effectively with the SEC and law enforcement, a company must be able to “identify . . . evidence with sufficient precision to facilitate prompt enforcement actions against those who violated the law”(Exchange Act Release No. 44969)
- Note that the SEC and FBI use computer forensics as a primary investigative process in their enforcement activities

Getting It Right: Royal Ahold

- Strong Cooperation in The Face of an SEC Inquiry
- Provided 500 Disk Images to SEC Investigators
- SEC Declined to Penalize the Company (individuals only were charged) after determining that proper cooperation was provided

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Electronic Investigative Process



Preservation

What ⇒ Carefully define scope

When ⇒ Litigation is “in the air”

How ⇒ Copy v. forensic imaging

Who ⇒ In-house v. experts

Where ⇒ Office, home and third parties

Scope of Preservation

- Relevant People & IT Systems
- Accessible vs. Not Reasonably Accessible
- Active & Inactive Data
- Multitude of Evidence Sources

Preservation Issue

“Helpful employees “organized” their files prior to forensic imaging.”

- Moving or copying files using Windows changes metadata
- Conservative measures need to be taken to ensure that alteration and/or spoliation of data does not occur
- An announcement, usually via email, can be delivered to employees regarding appropriate document retention guidelines

Preservation Issue

“Under our document retention policy, our email server is set to purge email older than 30 days.”

- A review of employees' computers and network home directories reveals years of archived email
- Employees will often create multiple backups of email, sometimes due to prior system failures
- Turning off the automatic purge of email should be addressed

Retrieval Methodology

- Terms

- Recall percentage of all responsible documents retrieved
- Precision – percentage of responsive documents among the set of documents retrieved

- Retrieval Types

- Boolean
- Conceptual
- Language



Analysis Considerations

- Email & Attachments
- Unsearchable documents: RightFAX
- Online Review
- Maintaining Context

THE FUTURE

- Clarity in Legal & Regulatory Environments
- Document Retention & Management
- Enterprise Investigative Infrastructure

Panel Discussion